CONWAY• JARVIS LLC
Investment Outlook

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Divergent Returns Hint of Trouble for the Global Economy

Since we last published at year-end, a number of global economic events have roiled the markets. Last year we saw the Fed tapering, the Russia-Ukraine conflict, the Ebola scare, and a downturn in oil and commodity prices. This year we saw that downturn become a bear market in Energy and Industrial Commodities. Add to that the Greece/Euro crisis, big questions surrounding China's economy, and an imminent change in Fed policy weighing on stock prices. These events undoubtedly present opportunities for traders. For investors, most will turn out to be only footnotes in long-term performance. Despite all the drama, US stocks posted modestly positive returns in 2014 and have been relatively range-bound in 2015, offering only low single-digit returns year-to-date. However, those numbers don't reflect some wild divergences within the indexes and in the returns from the global markets. Those are significant and tell a story of a dramatic bifurcation among economies and markets that can present challenges for the global investor.

Perception vs. Reality in the Global Economy

2014-'15 have provided plenty of dramatic headlines for the economy and its markets. Traders sold on the headlines and moved markets for brief periods. However, in each case long-term investors refused to follow traders to the exits. Why? None of these events have proved to be threatening a change to the upward trajectory of the US economy. And in the current environment, the direction of the US economy determines that of the Global Economy. Many in the financial media have fostered the perception that the recovery of the US economy is sub-par and is on a perilous path. While we acknowledge their need to sell advertising with such drama, we couldn't disagree more with their conclusion.

The current reality of the US economy can be found in the data. Employment is improving and creating wage pressure, Housing is in good shape, as are auto sales. Consumption, making up 2/3 of GDP growth is starting to look like it's ready to kick into another gear. What's missing is steady improvement in manufacturing and a level of robustness in CAPEX spending by business. That word, *robust*, is what's been missing from this recovery and perhaps why it's been so disparaged along with one of the longest bull markets in history.

What happens in the next year will be critical in taking the global economy into expansion or recession. Our biggest worry: Has China cooked its books? If they have, this could create a demand deficit for Industrial Commodities, Materials, and oil that would overwhelm suppliers around the world and undermine the global markets. That could prove to be too much of a burden for a healthy US economy to shoulder.

Looking Behind the Index Returns

When looking at the S & P 500 from 10,000 feet, US stock market performance appears *flat* year-to-date. It's traded at plus or minus 3.5% from where it began the year to where it currently rests. However, when drilling down to the sectors within, the variance of returns is significant. This year's decline in Energy and Industrial Commodities of -14% has taken both sectors into bear market territory. That indicates uncertainty for the Global Economy while at the same time those lower input prices should act as tailwinds for US consumption and

CAPEX. On the upside, Healthcare led at +13.6%, Consumer Goods and Technology followed at almost +5% and Services and Financials roughly in-line with the Index. When we include the NASDAQ return of 7+% there's reason to believe the stock market has few worries about the US recovery but has serious concerns about China and the rest of the world.

The Global Market, as represented by the MSCI All-Country World Index appears just as tame as the S & P 500 but behind it's modest 2% year-to-date return lurks EAFE, up 5+%, and Emerging Markets *down* -8%. Apparently, Denmark was the place to invest this year at +38% joined by Japan at +20% as the only two bull markets in the world. Contrast those to bear markets in Brazil, Columbia, Greece (no surprise), and Panama, down -29-33%. These big deltas and the bear market in Energy and Commodities indicate to us that, while the US is entrenched in recovery, the same can't be said for the Global Economy. That'll require resolving uncertainty surrounding China's economy and seeing Europe's recovery become more broad-based. For now, it's critical to the markets that the US continues to do the heavy lifting for the Global Economy. That requires a willingness of the Fed to avoid acting preemptively with regard to interest rates.

The Challenge For Investors Today

Our decades of experience have taught us that all successful investors adhere to some well-established principles. First, define yourself. You're either a trader or an investor. Trying to be both is a recipe for failure. If you're a trader, read no further and turn to CNBC. If you're an investor, you've defined your personal view of money, it's purpose within your life, a time horizon for its investment and use, and a level of risk you'll assume. Secondly, adapt your methodology to *big* changes in the investing landscape (bull and bear markets), not the insignificant and transitory. Thirdly, turn off your TV. Seek information and advice from credible, objective sources with nothing to sell but their service. Avoid drama and embrace analysis.

These principles are especially relevant in this news-rich environment. Diverging sectors and foreign markets are indicative of the risks in certain industries and countries that could undermine the anticipated global expansion. The success of our portfolios is directly linked to an improving US/Global economic cycle. China concerns sent oil and commodities spot prices to record lows this summer. The resulting bear market in Energy and Industrial Commodities stocks has been a trader's delight. As investors, we're willing to accept the under-performance of sectors that represent attractive value propositions within the time horizon we've established for portfolios. That also includes Interest-Rate-Sensitive stocks that have under-performed since April. We make this decision based on the view that the US recovery will spur that of the global economy, that the markets will reflect that, and that these sectors will participate.

While we could see a negative quarter or two in the next year, as investors we're not tempted to trade around those events and conditions that we view as transitory. We believe the "cost" of diversifying globally and in under-performing sectors will be returned with a premium as the global economy tracks higher. For that to happen, we'll need the Fed to adhere to its "data dependent" strategy of normalizing interest rates. On that subject, the return of higher interest rates will likely be viewed as a temporary negative by the market. We have no doubt the Fed *will* raise rates and that it will be well telegraphed to the investment community. We believe the current data doesn't justify tightening in 2015.

Others see it differently. According to CNBC, the Fed will move to raise key rates in a) September or b) December. The vast majority of investment professionals and commentators agree. We don't. We'd look for a change in Fed policy sometime in 2016 as the result of further improvement in the US economy. We view the strong dollar and lower oil prices as tailwinds for US consumption and CAPEX. If our economy can claw its way back to a "robust" condition, that should take the Global Economy higher, absent any nasty surprise from China. If that proves to be the case, the divergences we're seeing today should give way to the tidal forces of a broad-based global market advance and push any thought of recession in the near-term well down the road.

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