CONWAY • JARVIS LLC
Investment Outlook

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Time for Investors to Adjust Expectations

As if last year wasn't bad enough. 2015's poor stock performance not only reclaimed the gains of the prior year but also set the stage for this year's grim start. Despite the US economy showing slow and steady improvement, stocks have taken a round-trip during the previous two years from and back to January 2014 levels and it's been anything but smooth sailing in a sea of headline-driven volatility. Q1 '16 started amid the ongoing clamor surrounding China's slowdown coincident with a worldwide oil glut. The resulting widespread weakness in commodity prices has raised the prospect of numerous bankruptcies in the resource sector amid deflationary pressures that some say could trigger a recession for the US and the Global economy.

The China Effect

It's real and will have a long-term tangible impact on the markets. Other headlines of the post-2008 period have had little lasting effect on the trajectory of the US and Global economies. They only produced a temporary roiling of the markets in the short-term that inevitably faded as short-attention-span traders move on to the next bit of news. This pattern has been repeated often during this most unloved bull market that has endured for 7 years. However, the story about China's slowing economy has inexorably moved to the front page over the past several years and will overhang the Global Economy for some time. It's worthy of investors' attention.

Historically, a cyclical slowdown of the world's second largest economy wouldn't trigger a global recession and we don't believe it will now. That said, while China's attempt to transform its centrally managed, industrial-based economy to a free-market, consumption-based economy is a good thing in the long run, it's a long process and there are significant challenges along the way. China has been its own best consumer of industrial goods for decades as it's built great cities, highways, and transportation systems in anticipation of its population aspiring to a higher standard of living. Today, there's evidence that China's manufacturing capacity has far exceeded the growth of both internal and global demand for its industrial products. China's appetite for resources has dramatically declined as a result and explains the persistent decline in commodity prices that has lowered growth expectations for the Global economy.

Unfortunately, China's economic transition coincides with the Saudis' effort to regain their pricing power by bankrupting US shale oil and gas producers by means of an unprecedented price war. That combination, along with the strong US dollar has dampened the prospect for anything more than low, steady growth for the world for some time to come. Just as we believe we won't see a recession in the near future, we are not likely to see the word "robust" and "growth" combined in any sentence describing the state of the US and Global economies. Until Europe emerges from its malaise, China's growth rate stabilizes, and oil prices find a bottom, investors will have to lower their expectations for stock market returns until conditions improve to where the Fed can complete its intended "normalization" of key interest rates.

That doesn't mean we expect to see negative returns for the next 3-4 years but we do expect the market to reflect the long and low upward growth trajectory of the US economy.Without a much needed fiscal policy assist, it unlikely that we'll see market returns exceed their historical average for the next two to three years. We'd like to be proved wrong.

A Look Ahead

Unfortunately, expectations for modest stock market returns linked to a lengthy, low growth economic outlook won't necessarily translate to lower volatility. In the post-2008 period the market has reacted to events more like an emotional barometer than a capital formation tool. Yes, it remains an efficient *pricing* mechanism but often reflects how investors *feel* about world events rather than what a company's stock should be *valued* at in the longer term. It's hard to disagree with those clients that compare today's market to a casino. Headlines drive action in the market regardless of whether events are impactful to the economy. The periodic disconnect between the stock market and the economy during periods of high volatility is becoming routine. Traders love it. Investors do not.

Here's a list of items that have head-faked the stock market in the past 5 years: The Greek exit from the Euro. The US Government shutdown. The faux recession of 2011. The Fed will raise rates (2012). North Korea readies to launch a missile attack. The Fed will raise rates (2013). The Russians overtake all of the Ukraine and destabilize Europe. The Ebola scare. The Fed will raise rates (2014). China will suffer a hard landing for it's slowing economy. Europe's recession will tip over into a depression. The Fed raises rates, finally (2015)! The Saudis will bankrupt the US oil industry and the banks. The Fed will raise rates multiple times this year (2016). Of all these, China remains the only credible story and our primary focus because of its potential and significant impact on demand for goods and services. What happens in China will affect all theaters of the Global Economy.

Don't look to TV for answers to these issues. In our view, tabloid journalism has overtaken financial television media in the pursuit of ratings and to the detriment of the long term investment community. Our advice? Leave the drama to traders and instead watch the Nightly Business Report on PBS or read the Economist, the Financial Times, and the Wall Street Journal. We've said it here before: Investors should embrace analysis rather than entertainment when looking at their portfolios. We've heard from a number of clients who have done exactly that and say they're less anxious about the markets and less inclined to make emotional decisions about their investments.

The foregoing is our way of saying to investors that volatility is here to stay and that, despite the wild ride, holding stocks for the long-term will provide the best long-term returns available from all asset classes. The key to successfully participating is to gain self-awareness of one's view of money and appetite for risk. In short, know thyself. Return on investment directly correlates to the level of risk taken. Successful investors know that and don't plan their lives around the short-run machinations of the stock market. They sequester the market's volatility from their lives and don't pursue a rate of return at the expense of liquidity. Make sure your annual budget isn't included in what you view as investment capital and you'll breathe a little easier when reviewing your portfolio.

We see the beginning of 2016 as somewhat reminiscent of 2009 where we completed the crash of '08 on March 10 of that year. We finished that year with index returns upwards of 25%. While we believe this year will produce a positive rate of return, our expectations are far more modest than what we saw produced in 2009, thanks to the China Effect.

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www.conwayjarvis.com