First Quarter 2016

The Future Ain't Like It Used To Be

-- Yogi Berra

One of my clients wrote to me: "Malcolm. I am sick of all of this market volatility. Can you make it stop please? ☺"[1] If you've been following the news, you heard that the stock market had its *worst first week ever* for a New Year this year. It turned out to be the *worst first two weeks ever* before prices finally stabilized in the third week. Unfortunately, I think this volatility may be with us for a while.

There have been plenty of reasons for investor angst. The Chinese stock market crashed despite efforts by its government to prop it up. Political tensions increased between Iran and Saudi Arabia. North Korea claimed to have successfully conducted a hydrogen bomb test. And reflecting the malaise in the global economy, oil prices collapsed to levels not seen since 2003.

There was also some excellent economic news, although you may have missed it amid Wall Street's drama. Job growth in December exceeded expectations and job growth for the prior two months was revised upward. The unemployment rate remains steady at 5%, despite evidence that more Americans decided to enter the labor force. These are signs that the labor market is improving.[2]

What seems to be unsettling investors the most are fears that the U.S. economy is sliding into a recession, like much of the rest of the world. Every time stocks take a dive, investors ask if a recession is unfolding. Stock prices typically do fall before recessions, but they are simply too volatile to predict one. In 1966, economist and Nobel Laureate Paul Samuelson quipped, "Wall Street indexes predicted nine out of the last five recessions."

My colleagues at Verity and I don't think a recession is likely this year. The economy could hit a "soft-patch" and slow somewhat. U.S. manufacturing slowed through much of 2015. But, there are few other signs of an impending recession and consumers are in good shape.

Instead of recession fears, there could be a different dynamic at work. Investors' inflation expectations may be falling – quite a lot. A meaningful shift in long-term inflation expectations could impact how investors value stocks and bonds. This view is not yet widely expressed in the popular media, but some prominent analysts and hedge fund managers are already talking about persistent deflation.

Deflation was apparently a hot topic at *The World Economic Forum* in Davos, Switzerland last week.[3] The Forum attracts dignitaries, Nobel Laureates and many of the brightest minds in economics and finance. Hedge fund billionaires *George Soros* and *Ray Dalio* both discussed in separate interviews that China is spreading deflation to the rest of the world and that this trend could persist for years.

China is down-shifting from 8-9% annual growth to 4-5% and its slowing economy is weighing on the prices of many raw materials. The country is going through a long and painful transition from an economy dependent on government construction and investment to one driven by consumer spending. Its demand for commodities that it once consumed in great volume is declining, suppressing prices and hurting commodity producers. China represents about 16% of the global economy and it imports enough to impact growth in much of the world.

China's slowing economy could reinforce two strongly entrenched deflationary trends: productivity and demographics. Improving productivity drives down prices as products become cheaper to make and deliver. America's growing ranks of retirees will have less income than they had in their working years. They'll spend less overall and more on healthcare and other services than "stuff."

Oil is not the only commodity falling in price. The chart below tracks the *Reuters/Jeffries CRB Index*. This is the "granddaddy" of commodity indexes with continuous data going all the way back to the early 1950s. In a remarkable development, over the past six weeks this index has fallen *below* levels where it is has bottomed every time over the past 40 years. *The index shows that commodity prices, broadly speaking, have fallen to levels not seen since Richard Nixon was President.*

Reuters/Jeffries CRB Index
1957 - Present

Source: stockcharts.com ***Horizontal axis:*** *Years '57 to '16* ***Vertical axis:*** *Index Values*

The *Reuters/Jeffries CRB Index* is broadly diversified with 19 different commodities. Most of the index is not energy related. The index is weighted 41% Agriculture, 39% Energy and 20% metals. The numbers on the chart are difficult to read because this is a 57-year chart.

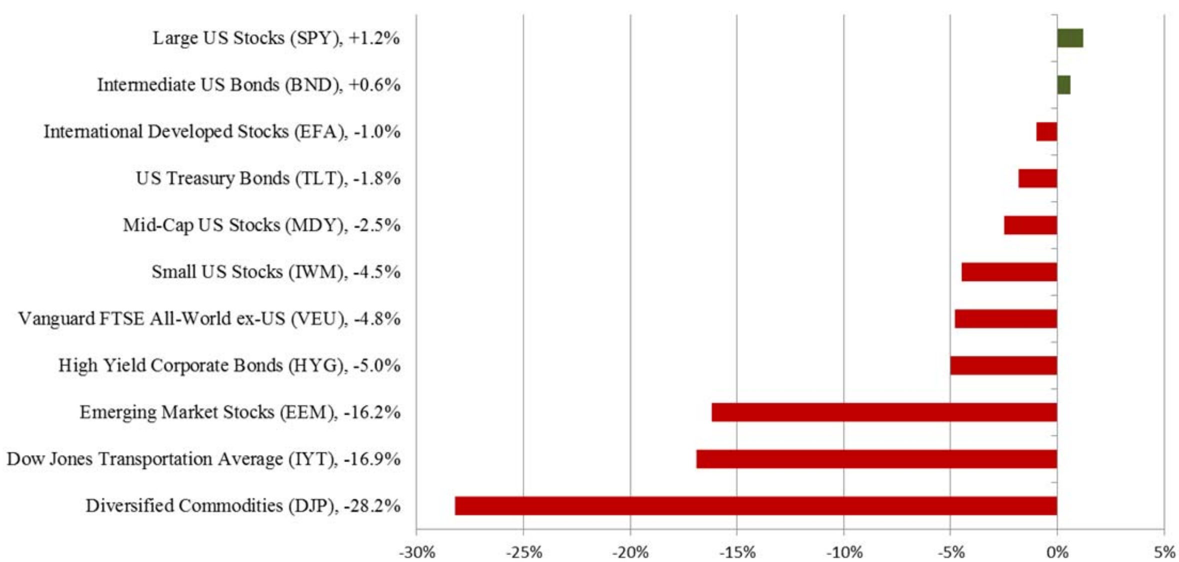
When will commodity prices rebound? The 1973 OPEC Oil Embargo ushered in an era of relatively high commodity prices that lasted for over forty years. That period may have ended. Most financial commentary I read expects oil and other commodities to rebound sooner, rather than later. However, the down-trends in this and other broad-based commodity indices are showing no signs of bottoming yet. It is entirely possible that commodity prices could remain depressed for longer than most investors now expect.

Consumer inflation has already dropped to nearly zero. The Consumer Price Index (CPI) averaged just 0.1% in 2015, despite the Federal Reserve's efforts to raise inflation to its 2% target. 2016 might be the first year since 2009 that inflation actually falls below zero.

If I am correct that investors' inflation expectations are adjusting to a new paradigm, then it could take time for this shift to play out in financial markets. Market history also suggests that it may be a good time for caution. Markets may not behave this year as they have in the past, but we can only look behind from where we came. [4]

- Large U.S. stocks, like those in the S&P 500, were among the best performing stocks in 2015, but now they have less company. A number of other major stock groups have already fallen into down-trends. These include: Small U.S. stocks, the Dow Jones Transportation Average, the NYSE Index, the All-World ex-U.S. index, and Emerging Markets.
- Large U.S. stocks themselves have become a more narrow market. Fewer and fewer stocks trade near their 52-week highs. This condition is consistent with market peaks.
- Back-to-back corrections in the S&P 500, meaning two 10% declines within six months, have preceded further declines. The current correction is the second in four months. This pattern is rare and has occurred only three times, which is too few to be statistically significant. But, the pattern's record is 3-0.
- U.S. Treasury bonds now have the best momentum among major asset classes. Bonds would normally be expected to perform well through deflationary periods and they could become the asset of choice for many investors. Bond yields may look more attractive to investors with lower inflation expectations.

2015 Market Performance



Source: finance.yahoo.com

I expect the stock market to resume its bull market sometime in 2016. The U.S. economy is in pretty good shape, especially relative to the rest of the world, and low commodity prices are great for consumers! Consumer spending is healthy and it will likely continue that way. Moreover, there's another economic boost coming later this year. As a result of improving state and local finances and the recent federal budget deal, which loosened spending and makes several tax cuts permanent, government spending is likely to make a positive contribution to GDP growth this year and next.

I am watching for signs that stock prices are bottoming. A near-term rebound could unfold. If the Federal Reserve begins to stimulate the economy again, then stocks could quickly respond favorably. Absent a change in Fed policies, if stocks begin a durable rally, indicators measuring trend, momentum, and breadth should also improve quickly to confirm the correction is probably behind us.

It is important to keep in mind that stock market downturns can be violent and unsettling. U.S. common stocks have created more wealth for investors over the long run than any other major asset class and they will weather this deflationary storm. After all, stocks are companies made up of people who are in business to make a profit. They will continue to seek ways to make money no matter the changing economic circumstances.

The current downturn may provide exceptional opportunities to acquire well-managed mutual funds and high quality stocks at attractive prices.

Thank you for your ongoing business and confidence. Let me know whenever I can serve you.

Malcolm M. Trevillian, CFA CMT
January 26, 2016

Notes:
[1] She knows who she is.
[2] Some of my comments were taken directly from William Hackney's January 11, 2016 commentary, "So… What's the Good News?" atlcap.com
[3] From businessinsider.com/george-soros-comments-at-davos-2016-1 and http://www.businessinsider.com/china-exporting-deflation-2016-1
[4] Quote from "The Circle Game," by Joni Mitchell