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2016: Fear Trumps Fundamentals

Happy New Year?

After a frustrating 2015, where most major asset classes either returned less than 1% or lost money outright, investors were welcomed into the new year with the worst first-week of stock market losses—EVER! After the 6th worst opening day since 1928, the S&P 500 continued to lose ground the rest of the week and by Friday the Index was down 6%, with the tech-heavy NASDAQ down 7.3%. And losses weren't confined strictly to Large Caps—by midday Monday, small cap stocks (Russell 2000) were officially in bear market territory, down more than 20% from their June peak.

The widespread losses in stocks stood in stark contrast to encouraging fundamental data that was released last week. The U.S. posted solid economic numbers (e.g., ISM-Service economy in expansion territory, continued growth in employment, and strong holiday consumer spending) as did Europe (the continent posted growth for the 30th consecutive month). While the *fundamentals* of a "flying at low altitude" economy remain in place, the *fear* of a Chinese slowdown took a stranglehold of the markets.

S&P 500 Worst First Five Day Starts to a Year

	S&P 500 Performance (%)		
Year	**First Five Trading Days**	**Rest of January**	**Rest of Year**
2016	-5.96		
2008	-5.32	-0.84	-35.03
1978	-4.69	-1.53	6.03
1991	-4.64	9.22	32.45
1962	-3.40	-0.41	-8.71
1969	-2.95	2.19	-8.67
1939	-2.66	-3.83	-2.58
1982	-2.45	0.71	17.64
1977	-2.28	-2.84	-9.44
1956	-2.13	-1.55	4.85
Average		0.13	-0.38
Median		-0.84	-2.58
Percent Positive		**33.3**	**44.4**

Last week began with the latest reports on the Chinese economy in conjunction with another devaluation of the Chinese currency. Selling ensued, with steep losses in Chinese equities resulting in the suspension of trading on their local stock exchanges (one day was shortened to a mere 30 minutes of trading). The government's plan, however, seemingly backfired. When markets reopened, investors quickly sold shares, fearful of another trading halt which indeed came to fruition. This negative circular cycle (i.e., selling pressure causing markets to drop—forcing trading halts which then lead to more selling when markets reopen) pushed the Shanghai index down 15% through today's (Monday, January 11th) trading.

If fear of a slowdown in the Chinese economy sounds familiar, it should. Four months ago, the same fears coupled with a similar currency devaluation were the key impetus behind the "summer squall" selloff in August. The strange twist last week was the fact that the newly published China economic data wasn't all that bad. According to Bespoke Investment Group, "*while data wasn't good, official PMIs (a measure of economic activity) both improved sequentially, with Services rising notably. Data compiled was slightly less optimistic but basically told the same story that has been true for some time in China: slowing growth with major pain in Manufacturing but no crash…due to sustained Services activity.*" The slowdown in manufacturing is by no means news; it has been a major theme for several years. Why the reaction now?

It's all about the Chinese currency; as investors are seemingly terrified of a Yuan crash and a resulting financial crisis.

But while the Yuan has weakened against the U.S. Dollar, it has been relatively stable against their other major trading partners. Case-in-point, since August, the currency has fallen by only 3%. And after a 35% gain the previous four years, perhaps the currency should weaken. A weakening currency is normal, and acts as a pressure-release valve for weaker economies. Consider Europe and Japan. Their currencies have been weakening for several years now, but few if any investors fear a crash of the Euro or Yen. But given that China is a newer economic power (one that's in control of the world's second largest economy) without a long track-record of banking and financial systems oversight, investors understandably have a case of the jitters.

But after taking a deep breath, investors need to consider whether the economic facts supports a potential crash in their currency. While we don't believe China is growing at 7-10% as it was 10 years ago, it shouldn't need to. A smaller growth rate, derived from a significantly larger GDP base, can still be impressive growth. Let's do the math. Ten percent growth in 2005 added an approximate $200 billion to GDP. A decade later, a 5% growth rate would add an amount north of $500 billion. In short—fears may be overblown.

The truth is, markets occasionally suffer tantrums, and we are clearly in the midst of one. Longer-term, investors will be wise to remember that equities not only yield more than bonds, they also offer a growing income stream as opposed to fixed-rate coupons. The extra volatility is the price investors must pay for potentially higher returns.

Shorter-term, investors will likely hear the old adage "as go (the first five days of) January, so goes the year." While this is true when equity markets are up (the S&P 500 has finished the year positive 85% of the time after a positive first week), it is less true when markets are down (the market has still finished positive more than half the time after a negative first week). Furthermore, when the first five trading days are down more than 2%, the rest of January and the year were merely flat. While not exciting, the data is a reminder to investors that a down first week in-and-of-itself is not a reason to sell. One must analyze other factors.

While relative valuations favor stocks, investors need a catalyst. Further analysis of similar periods reveals that large gains were historically confined to periods when the Federal Reserve was easing monetary policy. But with the Fed raising rates in December, the U.S. is certainly not in an easing mode. What should investors do? Over the next several weeks, investors need to keep a watchful eye perhaps not on China but rather on U.S. monetary policy. History suggests that a meaningful bounce might come if and when the Fed changes its tune.

As always, if there are any questions please do not hesitate to contact our office or visit us online at seia.com.

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