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Like Any Summer Squall, This Too Shall Pass

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STOCKS FALL

On May 21st, U.S. stocks (S&P 500®) reached an all-time high of 2130. But summer squalls overseas (Greece, China, etc.) have subsequently rattled global investors and caused many to hit the sell button, pushing stocks lower into "correction" territory – a drop of 10% from their springtime highs. The sudden bout of volatility may seem out of the ordinary but only because stocks have traded in their narrowest band ever through the first eight months of the year. But the lack of volatility is by no means merely a 2015 story. Over the last three calendar years, at no time have stocks retrenched more than 7% from their highs, which is in stark contrast to historical averages. Dating back to 1980, the average intra-year drop is 14.2%!

While many investors are now asking whether "*things*" have changed, from a longer-term perspective "*things*" are merely returning to normal. Simply put, markets go up and markets go down. But short-term bumps always merit a prudent reassessment of the global investment landscape – to see if anything has substantively changed enough to merit a shift in investment strategy. So, let's tackle the issues one at a time:

WHAT EXACTLY IS FUELING THIS SELLOFF?

Various pundits will point to one of a handful of headlines including an economic slowdown in China, currency wars, an emerging markets crisis, Fed monetary tightening, the plunge in Crude Oil prices, as well as high stock valuations. And while a reasonable argument could be made on the merits of each being the principal catalyst, more likely it's the cumulative effect of all these adverse factors that has prompted many investors to take some profits.

WILL THE ECONOMIC SLOWDOWN IN CHINA AFFECT THE U.S. ECONOMY?

The flashpoint of the most recent bout of selling seems to stem from China when they recently moved to devalue their currency. While currency fluctuations are normal, this devaluation sparked fears of a significant growth slowdown in the world's second largest economy. While concerning, the good news is that China has ample reserves and tools to combat a period of economic weakness. Any slowdown will certainly curtail profits of some multi-national companies, but at this point in time we see no indication of an overseas slowdown causing a U.S. recession. Just as the 1998 Asian crisis proved temporary, we believe this too shall pass with minimal domestic impact.

In fact, the U.S. economy is showing pockets of considerable strength. Low mortgage rates and robust existing home sales (recently hitting their highest levels in 8 years) act as a significant tailwind for housing-related industries (banks, home décor, construction, etc.). A continually improving job market which has added over 2.9 million jobs in the last year provides a tailwind for a variety of industries (commercial real estate, insurance, autos, and financial services) as more employees need more services. And let's not forget, low energy costs and low mortgage rates positively impact household budgets – the principal driver of consumption, which in turn fuels more than 70% of domestic GDP.

In short, leading economic indicators are still indicating growth. Banks have stronger balance sheets than the 2008-2009 crisis and we are finally seeing an increase in lending. Low energy costs and low interest rates are stimulative. None of these indicators point to an imminent slowdown.

HOW MIGHT THE U.S. MARKETS RESPOND?

Long-time readers will recall that we have been concerned about the high valuations of U.S. stocks for quite some time. Now, with a 10%+ correction factored into equity prices, many of those fears have subsided. While markets can certainly act irrationally in the short-term, long-term investors will recognize value at these lower price levels. If we are correct in our assessment that the U.S. will not enter recession, our calculations indicate that the companies that comprise the S&P 500 should collectively earn near $125/share in 2016. At a recent level of 1890, the market is trading at a 6.6x forward Earnings Yield (Earnings/Price) multiple. Compared to bond yields near 2%, the value in U.S. equities is compelling.

Markets can be remarkably resilient in the face of real and/or perceived crises. In analysing 75 years of "*market moving*" events (including The fall of France in WWII, the attack on Pearl Harbor, the Korean War, the Cuban Missile Crisis, President Kennedy's Assassination, President Nixon's resignation, the 1987 stock market crash, the Gulf War, the Gorbachev coup, the Collapse of Long-Term Capital, 9/11, the Iraq invasion, and the fall of Lehman Brothers), Putnam Investments found that while the mean initial drop was 10%, markets on average rebounded 6% over the following month and posted an average 25% gain over the ensuing twelve month period.

HOW WILL CHINA AFFECT GLOBAL ECONOMIES AND THEIR STOCK MARKETS?

Germany and Japan are export juggernauts, so any global slowdown would adversely impact their countries disproportionately. With 19% of their exports flowing into China, it's difficult to imagine Japan emerging from this current economic and market volatility completely unscathed. But similar to our view of the U.S., we believe the Chinese slowdown and its devaluation of the Yuan may trigger a temporary pause in the Nikkei's ascent, but is not sufficient cause to abandon an investment in Japanese equities. The reasons to remain bullish about Japan remain firmly in place, including the Bank of Japan's continued commitment to quantitative easing, more rapid profit growth than either the U.S. or Europe, stocks trading at a discount to the U.S., and a quiet revolution in corporate governance to boost Return on Equity. Given the vast cash hoards in Japanese corporate coffers combined with a dividend pay-out ratio that is far below that of Europe or the U.S., Japanese stocks show enormous potential for further appreciation.

CONCLUSION

In times like this, investors may feel the urge to "*don't just stand there, do something.*" But history suggests that in fact the best wisdom may be "*don't do something, just stand there.*" Focus instead on the things you **can** control. An important lesson, taught to me as a child by the Marines in my family, comes to mind: "Plan your fight, and then fight your plan." In other words, stick to your financial plan.

Try to keep emotions out of financial decisions. Breathe. Learn the lessons of past cycles. Diversify broadly, focus on sectors with tailwinds, and engage in trades now that will minimize future taxes down the road. This too shall pass.

Investors are forced to trade the market they have—not the one they want. Alas, we all must play the hand we've been dealt. If equity investors could dream, we would wish for extremely low interest rates, readily available credit, strong corporate balance sheets, low commodity and energy costs, low inflation, strong job gains, solid retail sales and a robust housing market. Oh yes—and low valuations. Unfortunately usually when this nirvana takes hold, the good news was already priced into the market resulting in stock valuations so high that any subsequent investment would actually be quite risky. Fortunately it appears that over these few last months in 2015, the hand being dealt may actually be an investor's dream

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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