A Time for Caution 11/6/2015

We are still on a bumpy ride as we enter into the fourth quarter of 2015. Let's take a closer look at the obstacles we are facing in regards to China, the U.S. economy, the Federal Reserve, and the stock market.

China:

On August 24th, the world suddenly seemed like a very small place. A tidal wave of stock selling that began in Shanghai had rolled all the way into lower Manhattan as China's problems became America's problems. Wall Street panicked and the Dow Jones Industrial Average (DJIA) fell almost 1,100 points - soon after the opening bell. The way this stock meltdown occurred, first slowly and locally, then rapidly and globally, says a lot about the nature of the world economy and the markets today.

In a genuinely globalized economy, excesses and imbalances in one corner of the world inevitably affect other countries (the last example - the U.S. subprime mortgage bubble). China is home to some of the biggest excesses with vast over investment in everything from real estate to commodities.

Last year, China accounted for almost 40% of global growth. Lately, we've seen China's economic growth slowing and its foreign policy is alienating its neighbors. The measures that China's government has taken to stimulate its economy hinder any progress of growth. Fueled by problems with real estate and banking, their debt quadrupled from 2007 to 2014. The recent economic turmoil in this country has led to a massive stock market correction.

During the time that China's economy was stumbling, U.S. markets behaved as they usually do. The markets tend to under react to new developments for a long period of time, and then abruptly over react – which accounted for the dramatic plunge of the Dow.

With our huge domestic market, the U.S. is far more insulated than other nations from the ups and downs of global trade. With that said, what happens in China's economy and how its leaders react definitely affects the world's financial markets – including our own. When China sneezes the world just might catch a cold.

U.S. Economy:

As we navigate the fourth quarter, the overall economy is struggling to deliver growth even as interest rates remain at zero percent. A few economic signs remain bullish - such as new home sales, but most evidence points to that of a slowing economy. Because of the strong dollar, U.S.

exports are on track to decline this year for the first time since the 2008 financial crisis. From railroads to manufacturers to energy producers, businesses say they are facing a protracted slow - down in production, sales and employment that will spill into next year.

Some areas like the industrial sector say they are already experiencing a down turn. Orders for durable goods dropped in September, which follows a larger 3% drop in August. Durable goods orders have been down in four of the past six months. U.S. factory activity grew last month at its slowest pace since 2013. Productivity growth rose at an annual rate of only 1.6% during the third quarter, a slowdown from a 3.5% increase in the second quarter. U.S. employers have also cut back sharply on hiring in September and added fewer jobs during the summer than previously thought.

Federal Reserve:

With job growth slowing substantially in recent months and the ongoing issues in China, the Federal Reserve (Fed) elected not to raise interest rates in October. While there's much more to the decision of raising interest rates that meets the eye, subdued economic growth and little inflation remain factors for not increasing interest rates. Last week, Fed Chairperson Janet Yellen told Congress that an interest rate move at its next meeting in December is “a live possibility.” These types of “open-ended” statements by the Fed continue to reinforce the uneasiness of the world’s financial markets.

Stock Market:

By nearly every measure U.S. stock prices are still overvalued. The lack of increasing revenue and declining earnings have caused a recent bear market correction for over 20% of the companies that comprise the Standard & Poors (S&P) 500 index. The correction also pushed more than half of the stocks in the S&P 500 into bear market territory, while the Nasdaq composite index had only six stocks that contributed to most of this year’s gains.

One by one stock analysts are slashing their year-end target prices. Despite the recent market rally in October, most money managers continue to fear that there is more volatility and downside ahead for stock prices. Even the Fed must privately wonder what will happen to stock prices once interest rates are raised.

Bottom Line:

Over all, the global environment is slightly bearish, the U.S. economy is slowing, and our stock market valuations are still too high. Add to this mix the unpredictability of the Fed’s interest rate policy - it's a sure bet the volatility and market uncertainty will remain with us through the end of this year and into 2016. Our short term outlook remains defensive and cautious.

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