Investment Perspective

KANAWHA
CAPITAL MANAGEMENT

7201 Glen Forest Drive, Suite 200 / P.O. Box 18490 / Richmond, Virginia 23226 / (804) 359-3900

SPEED BUMPS ON A DECENT ROAD

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Global stock markets sold off sharply in the third quarter. Many investors headed for the exits as if someone had shouted "fire" in a crowded theater. Investors' old nemesis — *volatility* — returned with a vengeance after a period of relative calm. The S&P 500 dropped 12% from its recent (and record) high, marking the first 10%+ correction in almost four years.

Predictably, many fear that this price action portends the beginning of a new bear market. *Perma-bears* have gleefully emerged from the woodwork after having been consistently proven wrong the last six years. While there are certainly a number of macro concerns today, it is important to view the recent sell-off in a broader context.

The long, high climb

First, from the depths of the financial crisis through this summer, stocks had appreciated more than 200%. And these gains have not been illusory, merely the artificial byproduct of Fed money-printing as some suggest. They have come with record earnings, profit margins and cash flows by corporate America. Second, stocks have typically experienced a 10% pullback about every 12 months on average. So the market has been long overdue for a breather, particularly given the significant rally.

Nevertheless, there have been a number of issues weighing on investors lately. The sharp sell-off in August seems to have been prompted by concerns for Chinese growth. China's economy has been undergoing a period of transition from excessive investment spending toward more consumption-driven growth. This will prove an uneven process and delicate balancing act. The challenge will be to execute this shift while moving to a more market-based financial system — without economic activity slowing too much.

Cracks in China

A gradual slowdown in China has been inevitable. But weakening economic signals, plus an unexpected currency depreciation, spooked equity markets this summer. Central authorities devalued the yuan, purportedly to boost exports and propel the economy. Loosely pegged to the dollar, the yuan had risen sharply against the currencies of most of China's trading partners, making Chinese products more expensive. Investors took the currency intervention as an admission that growth is on a sub-par track.

China has substantial buffers to deal with shocks, including sizable foreign reserves. But along with the yuan devaluation, policymakers' unconventional moves to prop up Chinese stocks have weakened market confidence in the country's current path.

Long gone are the heady days of double-digit GDP increases. And since China is the world's second largest economy, this step-down in growth has wide-ranging implications. Other emerging market economies are especially susceptible due to their strong trade ties, most notably via commodities. For instance, China accounts for 40% to 50% of global aluminum, copper, and iron ore consumption. One need only look at the sharp drop in commodity prices to gauge the impact of weaker Chinese demand. Further softening of Chinese demand for commodities and investment goods would undermine growth in emerging markets.

Containing the ripple

China is important. The other developing economies, as a group, are important. To the extent there is a negative shock that ripples across the globe over the next year, it will likely come from this area. Indeed, the International Monetary Fund just stipulated that financial risks have "rotated" from the developed to the developing world. But the global economy has been able to withstand previous emerging market crises such as those emanating from Latin America (1980s), Mexico (1994), East Asia (1997), and Russia (1998).

China represents the third largest regional market for U.S. exports after Canada and Mexico. But at 13% of GDP, our overall export sector is dwarfed by other segments. Total exports to China account for only about 0.7% of U.S. economic activity. Obviously, the feedback loop from a slowing China will have a broader impact than suggested by these figures, but unless that economy implodes, the United States should weather the storm.

U.S. ripple is strong

And in this summer's stock market turmoil, many seem to have lost sight of the fact that the United States economy is plugging along pretty well. The housing sector has been a notable bright spot as it slowly recovers from the bubble that burst in the mid-2000s. Housing starts have risen 11% this year, and yet the pace remains well below normal levels with room to further rebound. Total construction spending — residential and non-residential, public and private — has grown 10%. This sector is highly cyclical and has a significant multiplier effect across the economy.

Thanks to a tightening labor market, rising wages, and increasing home values, the U.S. consumer's financial position has strengthened considerably over the last several years. Household net worth has returned to record levels. In contrast to the export sector, consumer spending accounts for almost 70% of the U.S. economy; it makes up 17% of *global* GDP. So, as goes the consumer…

Corporate clouds hide a bright sun

However, the strength of the American consumer notwithstanding, corporate profits have increasingly come under pressure as the year has progressed. The strong U.S. dollar is partially to blame. Corporate management has been lowering the bar and Wall Street analysts, their forecasts. On a year-over-year basis, earnings for the S&P 500 actually dropped in the first and second quarters and are expected to show a 4% to 5% decline for the third. Not surprisingly, this trend has contributed to the stress in the stock market.

But the earnings picture is not as cloudy as it seems. Business has indeed slowed, particularly for companies exposed directly, or indirectly, to the energy and mining industries. Plummeting prices have led oil producers to sharply curtail their exploration and production budgets and overall capital spending. As a group, energy companies have reported more than a 50% decline in earnings. This has masked profits in other industries. For instance, excluding the energy sector, the S&P 500 has actually been experiencing EPS *growth* in the mid-single-digit range this year. Not great, but also not the disaster that some seem to be inferring.

After a period of relative calm, stock prices have returned to an environment of more pronounced swings, both within the course of a given trading day as well as from one day to the next. In this context and with the sell-off in recent months, some investors are understandably questioning the prudence of continued stock exposure.

The Berra market plan

> *You've got to be careful if you don't know where you are going, because you might not get there.* — Yogi Berra, *philosopher & catcher*

To paraphrase Yogi Berra, one needs a plan. As with any investment, stocks are really just a means to an end. They are intended to grow one's capital and income (through rising dividends) over time. These resources are then available to pay for future needs while protecting one's purchasing power from inflation. The tradeoff, obviously, is that unlike bonds, stocks do not warrant that holders will earn a specific return or ultimately even recoup their initial investment. Cash and bonds, on the other hand, are perceived as "safer" but will have difficulty keeping up with inflation.

Over shorter periods, stock prices may bounce around and even drop quite sharply. So when thinking about stocks, the operative term is always *over time*. History has demonstrated that stocks as an asset class typically produce returns superior to those of cash and bonds. They also generally achieve positive returns. The longer the holding period, the greater the odds of a desirable outcome.

The future is still what it used to be

The holding period is key. For instance, looking at all 12-month periods from 1926 to 2014, U.S. stocks (S&P 500) posted positive returns 75% of the time. Over 5-year periods, the odds increased to 87%; and over 10-year horizons, to 94%. Is the stock market like a casino, with the odds stacked against investors? One has only a 45% chance at winning at roulette, 48% at blackjack, and 49% at craps.

Similarly, the length of the holding period also influences the degree of potential downside. Again considering the 1926-2014 timeframe, over 1-year periods, the worst annual return was -43%. Over 5-year periods, the lowest annualized return proved to be -13%; and over 10 years, a negative 1% annually. The lowest annualized return over 20-year periods was +3%.

Given time, stocks will work out; but one must have the capacity to grant that time. That is not to suggest that one should blindly hold onto all their stocks when some defense is warranted. But ideally, investment dollars devoted to stocks should be those that will not need to be withdrawn for a number of years. The point is to structure the portfolio to put the odds in the investor's favor.

Not like déjà vu all over again

It is difficult to watch stocks plummet as they have in recent months. But this market action seems more likely to be a temporary interruption of the bull market we have been in since the end of the financial crisis than the beginning of a new bear. It is at least the fourth such "interruption" we have seen during the current cycle.

This is not 2008-09, when a real estate bubble burst and the banking system seized up; nor is it 2000, when a technology bubble deflated and a broad swath of extremely overvalued stocks needed to come down to earth. Moreover, bear markets typically coincide with broad economic slowdowns. The risk of a looming U.S. recession is higher now than a year ago, but is still low. So, with many high-quality, dividend-paying stocks down from their highs, we are more inclined to buy than sell.

— Christopher J. Singleton, CFA, Managing Director

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