Investment Perspective

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NOT THE PERFECT STORM

January, 2016

Good riddance

Most investors were more than ready to bid 2015 goodbye. The year began with a weather-induced economic slowdown in the United States. Then, suggestions of a Greek exit from the E.U. renewed fears of a European banking crisis and the end of the *Grand Experiment*. In the summer, the decelerating Chinese economy prompted some awkward policy moves including the devaluation of the yuan. As the leaves changed color, attention returned to the Federal Reserve and the threat posed by potentially higher interest rates. The year then ended with a further meltdown in energy prices.

This environment was like a perverse game of whack-a-mole. The stock market's attention bounced from continent to continent and concern to concern. How many times over the last few years have talking heads revisited the subject of a U.S. slowdown, European stress, China's hard landing, and Fed policy? Global terrorist activity and the vitriol seeping in from the U.S. presidential election season — a season that never seems to end — added to the unease in 2015.

Events during the year took a significant emotional toll without much to show for the pain. A *Barron's* article aptly characterized the U.S. stock market as being "violently flat". And it was propped up by a handful of stocks. Indeed, absent the surging performance to the so-called FANG group (Facebook, Amazon, Netflix, Google), the S&P 500 was down almost 5%.

Global equity markets ended up being almost universally weak while the returns for most other asset classes were also disappointing. And investors can only be further unnerved by the sell-off that has spilled into the New Year like water over a levee.

Wild patterns

The stock market's behavior has proved as volatile and capricious as the recent weather. Beginning in the fall, it became apparent that the world was confronting a very strong El Niño, an anomaly that causes wild fluctuations in weather from region to region. El Niño tends to occur every two to seven years. It is caused by the periodic warming of ocean waters in the eastern equatorial Pacific Ocean. The warmer waters interact with the atmosphere to alter global weather patterns.

Severe droughts and significant flooding in many parts of the world are being attributed to this El Niño. In the United States over the next several months, El Niño is expected to cause heavy rains and cooler than average weather across the South, with the potential for coastal flooding in California, along with relatively mild and dry weather in the Northern states. The effect should remain strong through the winter before finally easing by late spring or early summer.

Investors must be wondering whether financial markets are confronting their own anomalous forces. It *has* been a season of extremes, of droughts and floods: sharply higher and lower stock prices; a surging dollar; collapsing commodity prices; spiking credit spreads; negative yields on certain sovereign debt. No wonder skepticism is so pervasive.

Don't blame the weatherman

It is inherently difficult to predict the weather despite the best efforts of seasoned meteorologists armed with formidable computing power. There are simply so many factors that interact with each other, often in irregular ways, to produce the weather. Sometimes, the best one can do is discern patterns and cycles and then draw general conclusions.

Stock market prognostications are even more daunting and unreliable, particularly shorter-term ones. Forecasters must account for an additional element that their brethren in the meteorology field need not consider. That critical and unpredictable factor involves human emotion and decision-making. At the extremes (market tops and bottoms), humans tend to act in certain predictable ways. But in between those points, all bets are off.

Take forecasts at face value

However, one would not sense such a limitation from the strong conviction with which stock market predictions are typically made. And with the calendar turning, it is that silly season where many pundits, Wall Street strategists and miscellaneous billionaires are making market calls. With the recent sell-off, media types have added the perma-bears back to their IPhone contacts list and the cacophony is further fueling the fire.

The Motley Fool examined the forecasts of twenty or so strategists from the biggest banks and brokerage houses over the 2000-14 period. These were annual forecasts for the performance of the S&P 500 Index. On average, the experts missed a given year's actual market performance by fifteen percentage *points*.

So the lesson is to be wary of short term forecasts. Someone is bound to be right, but who? And chances are he or she won't make the correct call the next time around. Regrettably, the mainstream financial media do not hold guests accountable for their pronouncements and predictions.

And don't extrapolate

In any event, investors should not dramatically change their investment approach based on the prevailing "wisdom" of the day. They should also try not to react to the daily tape. One of the greatest mistakes is to extrapolate recent history out into the future; to presume that an existing trend will persist indefinitely. This *recency bias* prompts money to flow into stocks after a great run and flee following a painful decline. Instead, closely consider the conditions that allowed those gains (or losses) to take place and determine whether they are still relevant.

To that point, stocks have been very weak into the New Year. What factors seem to be driving this market behavior and are they likely to persist?

The force awakens

To the surprise of few, the Federal Reserve's Open Market Committee in mid-December increased the federal funds rate target by ¼ of 1 percent. Although future policy moves will continue to depend on the economic backdrop, the central bank has clearly embarked on a new regime.

It has been eleven years since the last rate-tightening cycle ensued. Many pundits lament that rising interest rates will punish stock prices. While the federal funds rate anchors the short end of the yield curve, longer-term rates depend primarily on expectations for growth and inflation.

Those expectations are still fairly muted and likely to remain so, keeping pressure off longer rates. In fact, 10-year Treasury yields have *dropped* slightly since the Fed move. Moreover, it is clear from past tightening episodes that stocks actually tend to rise in value over the twelve months following an initial Fed move. The key determinants are the speed and magnitude of the rate increase.

Ned Davis Research looked at Fed tightening cycles over the post-war period. For "fast" cycles — those in which the central bank raised rate targets at consecutive meetings — the S&P 500 fell by an average of 3% over the twelve months following the first hike. In contrast, for "slow" cycles — those in which the Fed waited at least one meeting between hikes — the S&P 500 rose an average of 11% over the next year.

Janet Yellen and company have continued to signal that this *new normalization* will be gradual. Low interest rates have been a byproduct of severe financial and economic stress. So it is good news that they may begin to reset. The Fed has changed its tune because the U.S. economy has gained traction, not because inflation is out of hand.

Oil's not well

Oil prices have continued to drop, with Brent crude trading below $30 per barrel in mid-January. That marked the first time in ten years that prices had fallen short of this threshold. Significantly, today's prices are also below those coinciding with the great global recession of 2008-09.

Typically, oil prices are pro-cyclical. That is, rising prices correspond with economic expansions while falling prices denote economic weakness. This was certainly the case during the last recession as demand receded and prices adjusted accordingly. But that is not the case today.

The current cycle is a bit of an anomaly. The demand for oil and its byproducts, gasoline and diesel fuel, has continued to grow — albeit at a dimished pace. However, over the last several years, the supply of crude has expanded dramatically. This phenomenon stems from both geopolitical and economic forces. U.S. production has taken off thanks to now-recoverable shale oil deposits. Saudi Arabia, the swing producer has continued to pump all out, presumably to drive higher-cost shale oil off the market and punish its regional rival, Iran.

Whatever the motivations, current production exceeds consumption and crude inventories are very high. Oil prices will therefore stay depressed absent a substantial output cut. The old adage that *"the cure for low commodity prices is low commodity prices"* still applies but it may take a while for production cuts to play out.

In theory, countries that are net consumers of oil should ultimately benefit from lower prices. The United States may be the world's top oil producer but we still consume significantly more than we produce ourselves. As their revenues were pummeled, U.S. energy companies slashed spending and reduced headcount. Manufacturers that supply the sector have also been forced to cut back. So falling oil prices have had a meaningful, and so far negative, impact on the industrial sector. But households have seen their gasoline expenditures drop by more than half.

Yuan or yawn?

The U.S. stock market's late summer swoon seemed to largely emanate from Chinese growth fears. Those concerns apparently receded and stocks came roaring back in October. With the benchmark Shanghai CSI 300 Index plunging 20% in recent weeks, U.S. markets again took their cue.

The world's second largest economy, China has indeed been decelerating. The current growth rate may well be the lowest since 1990. It has a huge debt overhang that must eventually be unwound. But China's equity markets are not indicative of the real economy nor are they very connected to international markets. So watching them for true signals is a losing proposition.

Various policy moves to intervene on behalf of the yuan, to support stock prices, and to offset capital outflows have been sloppy and ill received. Authorities seem to be caught in a fundamental tension between reform and control. This dichotomy has been causing market anxiety. And often, anxiety translates into selling pressure.

China's output will likely expand at a mid-single-digit clip which most of the developed world would envy. And policymakers have significant resources to shore up growth so the economy is unlikely to collapse. It will, however, remain one of the key stories in 2016, no doubt leading to ongoing volatility.

Earnings matter

The trifecta of sluggish foreign demand, a strong U.S. dollar, and low energy prices has conspired to pressure corporate profits. According to Factset, fourth quarter (2015) earnings for the S&P 500 are forecast to be down 5.3% year-over-year. If so, this would mark the third consecutive quarterly decline, the first such occurrence since 2009.

Sounds ominous but this is not 2008-09. While many businesses have indeed been struggling to grow this year, most of the drop in overall earnings can be attributed to the energy sector. Those companies will report a 60% decline for the full year. Excluding the energy group, the S&P 500 has actually been experiencing EPS *growth* in the mid-single-digit range this year. Not great, but also not the collapse of corporate America.

Fortunately, the underlying U.S. economy appears to be in fairly good shape. The consumer has led the way thanks to a strengthening labor market, lower debt levels, and rising home values. While businesses may remain somewhat reticent to spend their excess cash, consumers should continue to be the driving force this year.

To regain traction and resume their upward trajectory, stocks need an improving profit outlook. But as we have pointed out in the past, bear markets generally coincide with recessions. An economic downturn cannot be ruled out but it does still seem unlikely at this point. Nevertheless, quick pullbacks (5%-10%) are quite normal, even within a rising market trend. Given the unsettled climate, expect more of the same.

— Christopher J. Singleton, CFA, Managing Director

January 15, 2016