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John Dessauer's market review and update as of Wednesday January 6, 2016

Stocks are off to a rough start in the New Year. China's stock market plunged, falling 7% on Monday. That triggered a global stock selloff. But economic fundamentals in China, Europe and the United States indicate that the stock plunge is an overreaction, triggered by Chinese stock market regulators' missteps.

Several months ago, when Chinese stocks fell sharply, government regulators imposed a temporary ban on large block sales of stocks by insiders and institutional investors. That ban expires at the end of this week. Traders were worried that stocks might fall after the ban was lifted. Under these circumstances it didn't take much to trigger a selloff. Monday morning's news that manufacturing in China contracted in December, for the fifth straight month, gave traders a reason to sell. Stocks fell 5%, and then a recently imposed circuit breaker kicked in, and trading was halted for 15 minutes. During the break, sell orders piled up. When trading resumed, stocks quickly fell to the 7% day limit. At that point trading was halted for the rest of the day, leaving Chinese regulators with a challenge. Clearly, the circuit breaker needs modification. In addition, the government needs to address the liquidity issue. Temporarily banning large block sales of stocks does not solve the underlying liquidity issue. The ban only put off the day of reckoning.

China has made remarkable progress since the 1990s. Mao Zedong left a nation of roughly one billion in abject poverty. Today there are hundreds of millions of Chinese enjoying a western style middle class standard of living. The communist (in name)

Chinese government has accomplished this by slowly adopting free market capitalist policies, including stock ownership and trading. However, as has been seen recently, Chinese government regulators have a lot to learn. To their credit, they have adapted and quickly responded to each crisis. It may take several days - or even a few weeks - but the Chinese stock market is not going to spin out of control. Stock market stability will be restored.

The media focus on the decline in Chinese manufacturing. Pessimists chime in with forecasts of an economic hard landing. However, China is an economy in transition and it is easy for media pundits to misrepresent underlying conditions. Yes, manufacturing is declining, but the reason is overcapacity in two areas: steel making and shipbuilding. Excluding those two sectors, manufacturing in China is stable. The December data showed improvement in both supply and demand for China's manufacturing sector. Output in manufacturing rose in December and so did new orders.

The non-manufacturing or services economy is growing nicely. The official, non-manufacturing PMI (Purchasing Managers Index) rose to a sixteen month high in November. Chinese leaders say that, overall, the economy grew at a 6.9% pace in 2015 and can grow at 7% this year.

The stock market is not China's only challenge. Because of slowing growth and a volatile stock market, the Chinese currency, the yuan, has come under pressure. Having a high personal savings rate is a plus during times of rapid growth. However, that has become a serious challenge because of money flowing out of China in pursuit of diversification and better returns elsewhere. In addition to calming investor fears, officials in Beijing are hard at work keeping control of the currency. The two are, of

course, not truly separate challenges. They are directly connected. And keeping economic growth alive is the number one underlying issue. China's history of successes dealing with a long list of serious economic challenges says Beijing will be successful in dealing with the current stock market and currency challenges. There will be a series of supportive policy measures addressing the stock market and currency in coming days. The global stock plunge is an overreaction.

There is an adage: Wall Street climbs a wall of worry. The idea is that as long as there is plenty to keep investors worried, stocks are not going to soar, creating an unwanted bubble. This does not mean, as we saw in 2015, that stocks will provide exciting gains when there is a wall of worry. It does mean that, barring a fundamental economic setback, stocks will hold their ground and not follow the pessimists' dismal script.

Stocks often rally at year end as tax loss selling and profit taking abate. That was not the case in 2015. Stocks closed the year on a low note. The Dow Jones Industrial Average was down 2.2% for the year. The S&P 500 Stock index did better, but still was down 0.7%. The winner in 2015 was the technology stock heavy Nasdaq, which gained 5.7%. The year actually was better than the broad indices indicate, because the energy stocks fell sharply, dragging down the S&P 500 and the Dow Jones Industrial Average.

This year is likely to be the turning point for oil and the energy stocks. On the supply side, high cost oil producers are cutting back. Overleveraged fracking companies are being forced to cut back. These fundamental reactions to lower oil prices will help to keep supply from growing faster than demand. It is fundamental: when prices of things go down, supply decreases and demand goes up. While that did not seem to be the case in

2015, it is likely to be the case this year. Last year we saw, and markets felt, the consequences of the sudden collapse in oil and other commodity prices. Consumers took advantage of lower oil prices and bought new cars and increased their savings. By year end, the U.S. personal savings rate was up to 5.6%. What they did *not* do was run up credit card debt to buy a wide range of consumer products. While that might have disappointed some retailers and economists, it is very positive for the long run outlook for U.S. consumer financial health. For years before the 2008 recession, pessimists argued that the U.S. economy was heading for major trouble because consumers borrowed too much and saved too little. The plunge in home prices during the last recession provided those pessimists with some comfort. There were too many homeowners with too much debt and too little savings. American consumers have learned a lesson and have reduced debt and increased savings. This year we will likely see the benefits from lower oil and improvements in the broad economy show in increased consumer spending rather than a higher savings rate.

In a year end BBC interview, BP's CEO Bob Dudley said: "A low point (in the oil price) could be in the first quarter." He thinks a more natural balance between supply and demand could come back in the third and fourth quarters of this year. But that does not mean he sees a return to $100 a barrel oil any time soon. On the contrary - he thinks oil will stay low for at least the next two years.

If Dudley is right and oil bottoms out this quarter, the downward drag from falling oil prices will soon end. However, it will take some time before investors are convinced that has happened. Oil will remain a source of concern, if not worry, for investors for at least the next six months.

According to a year end article by Reuters, most experts are predicting a seventh year of stock market gains in 2016. A recent poll says the experts expect the S&P 500 stock index to end this year at 2207, for an 8% gain. When dividends are included, that would mean a double digit total return on stocks for this year. That would be a far cry from the spectacular gains a few years ago, but never-the-less welcome, especially after the disappointing gains in 2015. Stock market cycles end when either a bubble develops or the underlying economy booms and busts. The wall of worry that kept stocks in check last year is still intact.

China and oil are not the only bricks in the wall of worry. The U.S. dollar is another source of worry. Against a trade weighted basket of currencies, the U.S. dollar gained 8.4% in 2015. That made U.S. exports more expensive on world markets, and hurt manufacturing output. It also reduced foreign earned profits for U.S. companies. Profits for U.S. companies with foreign exposure were depressed by 3-4 cents per share in 2015. There is concern that if the Federal Reserve keeps raising interest rates while other central banks are keeping interest rates low to stimulate their economies, the dollar could continue to climb, inflicting more damage to U.S. manufacturing and corporate profits. Of course the Federal Reserve would not keep raising interest rates under those circumstances. If necessary, the Federal Reserve would reduce U.S. interest rates to keep the economy growing at a reasonable rate.

Another worry point is the violence in the Middle East, and the flood of unwanted refugees into Europe and the United States. Saudi Arabia’s execution of a high ranking Shiite cleric has intensified tensions in the region by infuriating Iran’s ruling leaders. Terrorism and the Middle East tensions will remain bricks in the wall of worry this year.

If all of this is not enough, John Manley, chief equity strategist at Wells Fargo Funds Management says: “the deepest fear I have is that we didn’t really fix it six years ago, we just delayed it for a little while. And rather than being sunk by a gash we are being sunk by a slow leak. It’s not what I think, but it is what I worry about.”

As long as we have equity strategists like John Manley worrying like that, we need not be concerned. The wall of worry is intact. Individual investors, as a crowd, are a contrary indicator. They fled stock mutual funds in the second half of last year. That indicates that after the current slump is over, stocks will deliver a better first half this year than they did in the second half of last year.

I will have the next market review and update for you one week from today on Wednesday January 13, 2016.

All the best,

John Dessauer

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