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Bad Market, Better Economy

A perfect storm of negativity has hit the market, with the major index falling 9% since the beginning of 2016. This is a continuation of the correction discussed in the second quarter 2015 newsletter, one that began in May and has now brought the S&P 500 down more than 12% from its May high of 2,130. It has been a rolling fall. From May high to August low the market also fell over 12%, then recovered to finish the year at a level just 4% below the high of May. The decline since New Year's has been dramatic but it is part of a larger pattern which is not so much dramatic as just simply bad. Officially, a fall of over 10% from a previous high constitutes a 'correction' while a fall of over 20% is considered a bear market. We have a ways to go before we are in bear territory but it is not inconceivable that we will get there.

After four years of steady rise it isn't surprising that there is a market correction. Market psychology operates to some degree independently of the economy and when the market decides to accentuate the negative then it can do so with a vengeance. There are of course plenty of negatives to go around. China is the most important one right now. Its growth rate has fallen from the range of 10% per annum in recent years to around 7% currently. Since market optimism has been so dependent upon an expanding China it is not surprising that any slowdown would occasion pessimism.

Europe too is disappointing. Again, not because it is in recession or even because its GDP growth rate has slowed, but just because its growth is not what we had hoped. Indeed, Europe has experienced some modest but nonetheless improved growth, from 1% in 2014 to 1.5% in 2015 and with a slightly higher rate projected for 2016. Japan continues to grow at about the same rate as the United States, 2 to 3%. It is interesting to note the anguish with which some American financial commentators discuss the possibility that our economic growth rate might be 2% rather than 3% this year. As if that would justify a bear market.

Other stock markets have behaved even more badly than our own. As of this writing, January 20, Europe's market is off an average of 12% since the first of the year and Chinas' is down almost 16%. Since the highs of last year these markets are down respectively over

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22% and 42%.

World trade in commodities is way down due to China's slowing demand, Europe's unemployment remains stubbornly high, the energy sector suffers from low prices due to a glut of oil and gas. Sales of America's largest corporations, represented in the S&P 500 Index, are down. But this is precisely because of energy and commodities. If we subtract those two items then sales are up 2% over the prior year and earnings per share are nearly 5% higher.

Whatever bad news we hear about the American economy is offset by a fairly consistent stream of good news. In November manufacturing activity was up, not down, when measured against the prior month. New factory orders in October were up over 17% compared to September. Construction spending was more than 11% higher than in September and over 13% higher than the prior year. Private fixed investment was more than 5% higher in the third quarter of 2015 than in the second and state and local government capital spending was almost double. Personal income and consumer spending are both 3 to 4% higher than they were in the previous year. November housing starts were 16% higher than in the prior year. 2015 American auto sales were at a record level. This Christmas season was better than the last, with retail sales up over 2%. Unemployment, at 5%, is at a level unseen for nearly a decade. In sum, the current

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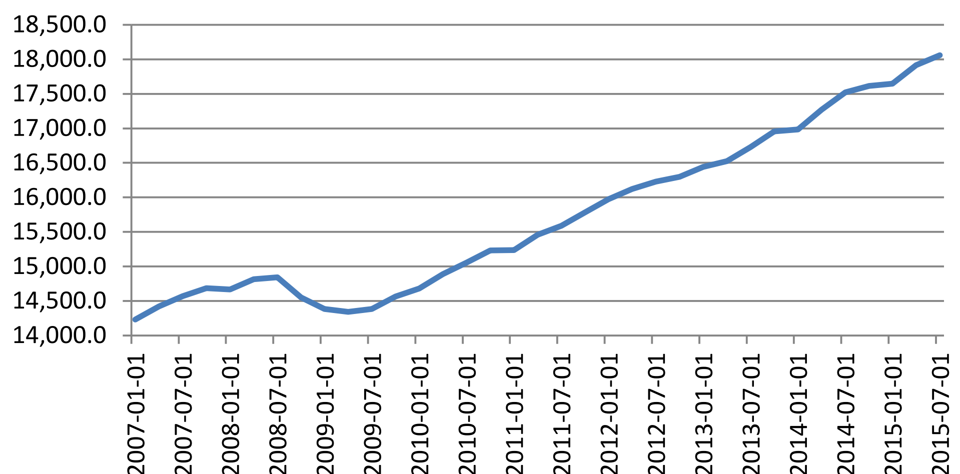
market turmoil is predictable, not unreasonable, though probably overdone. We won't predict how long it will last nor to just what level the market might sink before it rebounds. We also recognize that a bad market can spill over into the economy and create the damage that it says is already there. The odds are, however, that this will be not much more than a passing scare.

In situations like this our protocol is to sell at designated price points. Cutting losses, protecting profit, is the most important long term determinant of a portfolio's performance. When a stock reaches a certain price we sell a third, or sometimes a half, of a holding. If it continues to fall then we will sell again at the next lower price point. You may have noticed some sales in your own portfolios. Our intention is to build up cash reserves in order to be in a position to buy when the market gives a signal that it has reached a bottom. There are a number of issues that we will buy when the price is right. This includes some securities that we have already sold and will be bought back at the opportune time.



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