THE NORTH PIERspective

Market & Economic Commentary

Spring 2016

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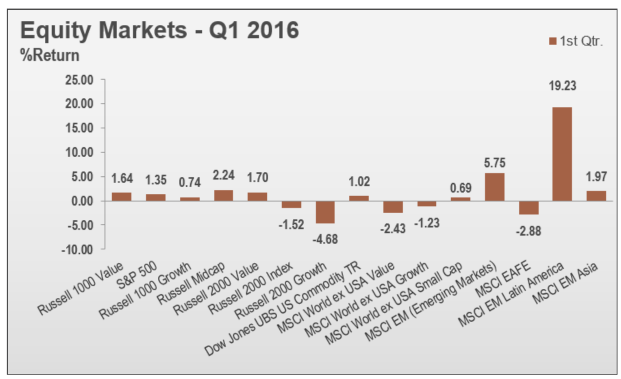
By: Jim Scheinberg - May 11, 2016

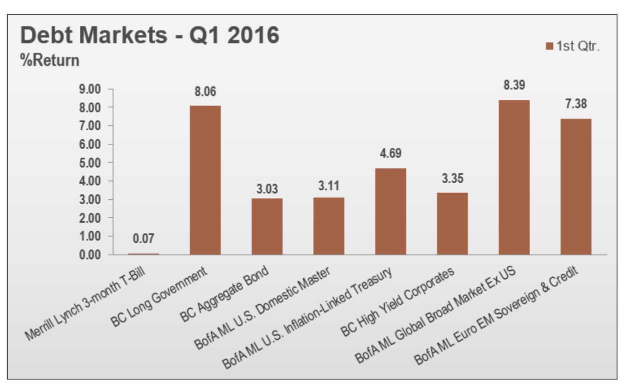
The Sky Isn't Falling! The Sky Isn't Falling!!

Quite like the rapid selloff and near instantaneous recovery we saw during the fall of last year, U.S. and global equity markets began 2016 with a quick plunge of over 11% (covered over just 12 short trading sessions). The pattern was almost identical to the steep correction we saw in August: a rapid fear–based decline, followed by a successful retest of those lows a few weeks later, before a steady climb out over the subsequent two months - almost completely erasing the losses of the correction. The reasons were identical as well. Worries over declining oil prices and Chinese economic weakness led to conjecture about these two items' indications about (or impact on) the broader global economy. And as was true with the alarms that were sounded in the fall, there was little actual data to support the borderline panic. As subsequent rounds of data rolled out, failing to show any signs of a looming contraction, the media-propagated myth that the sky was falling faded once again, and markets recovered.

How the Markets Fared



If one only looked at Q1 performance on the first and the last day of the quarter, it would be easy to think that it was a boring quarter in the equity markets. Most U.S. equity indexes saw modest gains of a percent or two. Smaller capitalization growth-oriented stocks were the only outliers. As appetites for risk diminished in the opening weeks of the year, small cap growth stocks, which are generally thought of amongst the most aggressive vehicles in U.S. equities, sold off nearly 19% and only rebounded in tandem with the recovery, netting nearly a five percent loss for the quarter. Larger cap stocks only saw modest underperformance from the growth side of the spectrum. International equities in developed markets generally saw slight declines, but in those markets it was growth stocks that fared better than more cyclically sensitive, value names. This is likely due to the general consensus that although the U.S. economy was on stable footing, the international picture was less clear. A bright spot internationally came from the emerging markets. Latin American stocks came roaring back after losing nearly a third of their value in 2015. This was led by a rebound in oil prices and commodities as a whole, which was seen as bullish for the natural-resource dependent economies. All in, emerging markets were the brightest spot in the equities market in Q1.

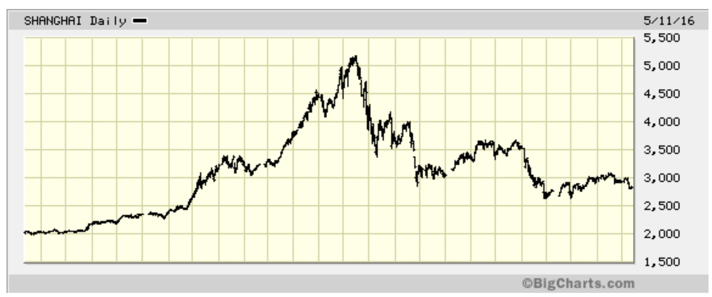


If modest total returns for the quarter made the equity markets look dull and more like the returns one would expect from fixed income vehicles, the gains out of the debt markets almost looked equity-like. Once the near-panic hit stock markets in the opening weeks of Q1, the flight to the perceived safety of U.S. Treasuries drove interest rates on the 10-Year Treasury down nearly three quarters of a percentage point at their February 11th lows (1.57%, a three-year low). The 10-Year, which started the quarter near a 2.25% yield, ended Q1 a tad above 1.75%.

This helped intermediate-term U.S. fixed income as a whole to rack up 3-4% net returns. This was true everywhere you looked from high yield to TIPS. The way they got there was not as smooth and immediate as with Treasuries, however. High yield, which had a difficult year in 2015 due to collapsing commodity prices, sold off even worse in the first few weeks of 2016, before mounting a robust comeback to finish the quarter in the positive. TIPS rallied as well, but that was due to awakening inflation fears, as gold finally broke its slumber, climbing 16% to over $1,250 per ounce. International bonds saw their first solid gains in over two years as 4% gains from a drop in the U.S. Dollar added to net bond returns.

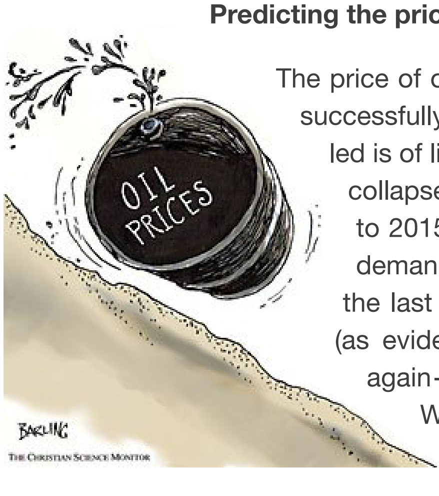
Fine China

China's economic growth is clearly decelerating, with expectations that their GDP will settle in at a new modern-era low of 6.5% this year. However, their financial position is stronger and more capable than most seem to factor these days. China has over $3.2 Trillion in reserves. That's more than the entire U.S. financial crisis bailout cost, and we had to borrow our stimulus dollars; they have theirs in the proverbial bank. After decades of wage improvements and subsequent standard of living increases, China is simply moving into a more mature, internally supported economy in which 6-7% growth is good, if not great. Take a moment to ponder that: the second largest economy in the world is only growing at 6.5% a year… That doesn't sound too horrible when one factors that U.S., EU, and Japan would all kill to grow at half that pace.



The focus on vast movements in China's stock market over the last several months was misplaced. As a reminder, the Shanghai Index went up 150% between June 2014 and June 2015! This meteoric rise was fueled in part by government encouragement for share-ownership for its citizens (think: the U.S. housing market in the years leading up to our crash in 2008). After the government curtailed limits on the use of leverage in their markets in June of 2015 due to too much speculation by investors, the Chinese market dramatically pulled back 45%. Net-net, however, it is still up approximately 40% in just those two short years. Why did the unwinding of a speculation bubble in China somehow become a proxy of prospects for the U.S. economy and stock market as well as those of the rest of the developed world? It shouldn't have.

Predicting the price of oil is a slippery slope



The price of oil bottomed near $26 a barrel on February 11th (the same day the stock market successfully retested its prior lows). Some may argue that one caused the other. Which one led is of little importance. Oil prices didn't collapse because of slack global demand—they collapsed because of massive oversupply. US production grew by 2.5M barrels from 2013 to 2015, creating a glut in global supply that was 1.7M barrels more than record global demand. In fact, consumption has consistently risen about 1.5% a year every year for the last 4 years. That is not a sign of a global slowdown. Subsequently, drilling activity (as evidenced by rig counts) has plummeted. Eventually, demand will outpace supply again—2017 maybe? Who knows, but it will happen within a reasonable period of time. Whether oil's recent rise to $43 is sustainable or not is less important than knowing that oil prices should not be looked at as an indicator of broader conditions.

Feeling Fit

The U.S. consumer, who is responsible for more than two-thirds of our domestic economy is still in remarkably good shape. Though consumer sentiment levels have recently shed a few points from their post financial crisis highs, confidence remains at robust levels last seen in 2006/2007. This is likely in response to the stock market selloff in the beginning of the year. We saw a similar dip and subsequent firming after the August correction.

Sentiment is likely to stay firm in the coming months due to continued strength in the labor markets. Unemployment remains low at 5%, and for those who are unemployed, they are likely to stay so for a short period of time. Continuing Claims are at the lowest levels since before the dot com bubble burst in 2000. With an efficient match of labor supply to demand, wages have continued to grow for American workers. Aggregate earnings for workers grew by 0.8% in April. This was led by an increase of 0.3% in hourly wages and an uptick in the average hours worked in the work-week.

Also leading continued positive outlook from many Americans, particularly those who are homeowners, is the continued strength in the residential real estate market. The Case Schiller 20 City index grew by another 5.4% year-over-year compared to February 2015. The National Association of Realtors showed a similar 5.7% gain for the year ending in March. Existing homes sales continue to be robust, nearing the 5.3 million units a month. Tight inventories have kept supply levels at a short 4.5 months, well below the 6 month norms; and low mortgage rates continue to fuel demand. This points to continued advancement in prices. Upward price trends are likely to keep homeowners feeling good, as well as spending money for home improvement projects: all additive to the economy.

Spunky Business

Purchasing manager sentiment, which is considered a good gauge of business conditions, continues to point to sustained growth in the U.S. economy. The Institute of Supply Management's Report on Business (ROB) showed that the manufacturing side of the U.S. economy continues to trudge along, with moderate growth. The April report came in at 50.8 vs. 51.8 last month; however, these last two months are the best on record for goods-producers since the fall market correction back in August. The ROB suggested that this reading corresponds to a 2.2%-2.4% rate for real GDP growth for the year ahead. Still more encouraging was the ROB Non-manufacturing Index (NMI) that was recently released. The NMI rose to 55.7 in April, indicating a 2.7% increase in real GDP ahead. Both reports show strong future orders, so business-to-business conditions should be firm for the coming summer months.

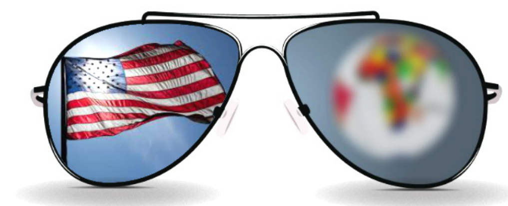
I'll trade ya!

Now that we've looked at conditions here at home, what about the international stage? The Euro-zone Purchasing Managers Index (similar to the ROB) actually looks reasonably stable. Italy, Germany, Spain, and Ireland are all showing expansion. France appears to be flagging in recent months, but is not yet showing signs of pending recession. Recent data out of the U.K. is less encouraging as well, but to a lesser extent. The IMF has predicted 1.0%-2.6% growth for these developed nations, but North Pier believes that upcoming data could diverge, leaving the Euro-zone with some winners and losers.

Japan's data is beginning to roll over into the negative, making the IMF's recent predictions for a half of a percent of GDP growth look optimistic. With the stabilizing of commodity prices, resource focused - economies such as those in Latin America should see improvement. The IMF's prediction of 4.1% growth for the EM as a whole should prove to be conservative if the upward trend in commodities holds. This will likely not be the case for Brazil, however, who is not only mired in economic problems, but political turmoil as well.

It deserves note that globally, trade is down across the board. Whether this is the early signs of protectionism or the results of last year's massive decline in the Euro vs. the Yen and U.S. Dollar (~20% for August 2014 through March 2015) remains to be seen. Year-over-year statistics started to be compared to the "new dollar" in April. North Pier believes that this will have more impact than is being projected. We expect the U.S. economy, due to favorable year-over-year comparisons in trade, to look stronger versus Euro-based economies, especially those focused on exports like Germany, France, and the U.K. Our Summer *PIERspective* will examine this new round of reports in more detail.

PIER*ing* Ahead



Last quarter we stated that the weight that China and depressed energy prices were having on sentiment and equity markets was vastly overblown. Whether we were correct may never be known, now that oil has climbed back from under $30 per barrel to over $43 at the time of this writing. Though it would be fool's folly to predict that the worst for the energy sector is behind us, we stand by our prior analysis that sooner or later, the supply demand curve would (or already did) normalize. This improvement has allowed real economic data to take center stage. There the story has stayed largely the same. Strong jobs, low debt, and bullish real estate conditions have a healthy consumer feeling confident. That confidence is shared by the business sector, especially in the services side of the economy. All arrows point to continued better times in the United States. Internationally, the picture is a bit muddier. Spots of concern such as Japan and France are joining the malaise of China, while parts of Europe and now the emerging markets are looking stronger. It may be too early to call how the international markets will fare as whole from here. More likely, they will disjoin, and go their separate ways on a country-by-country basis. Nonetheless, there don't appear to be any signs that a new round of fear or outright panic is warranted anytime soon. But then again, the last round didn't appear to be warranted either. We will be *PIERing* ahead to see whether things continue to improve, as we suspect -- or if new concerns develop in the months ahead.

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