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THE BI-POLAR INVESTOR
INVESTMENT STRATEGY
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2015 proved remarkably difficult in US financial markets and for the coming quarters we could have more of the same. In short, we look forward to choppy markets in 2016 driven by bi-polar investors who alternatively hope and despair over profits and economic growth. We are not however, in our best judgment, headed for recession, and we might by year end, have experienced a surprisingly good stock market. Here is why:

The slowdown in China's economic growth and the massive decline in the oil price (30%) in 2015 (after an already horrendous 50% decline in 2014) have some investors already fearing recession. These two factors have been and will continue to be important factors in the willingness of investors to risk money in stocks.

It is true that some sectors of the US economy are in recession – namely energy producers, raw material producers, and the stock prices of these companies are at or near their lows of March, 2009. We can expect to see any number of bankruptcies and takeovers in these sectors during the coming year! That bad news will probably adversely affect investor sentiment from time to time again this year!

Nonetheless, one should be careful not to assume that these parts of the US economy stand for the whole of it. On the positive side, the decline of the oil price has led to a $2 decline in the price of gasoline. That decline in gasoline prices should permit, by our calculation, about a 2% increase in spending on all other goods by consumers and businesses. We are only beginning to see this increase in the GDP statistics and retail sales numbers. Historically, it takes about 18 months before a significant oil price decline shows up in consumer spending. We are now beginning to see that with better than expected sales at Christmas, and so far we have seen very strong spending on home improvements and autos. The savings rate (what is left after taxes and spending), however suggests that improved consumer cash flow is also being used to pay down debt as the savings rate has been running 5%-6% for some time. All this means is that the consumer's capacity to spend is growing, and we would therefore expect to see continued 3%+ growth in real consumer expenditures this coming year. Since consumer spending represents about 70% of the US economy, it is the most important component of US growth.

Furthermore, household formation (children leaving home to go out on their own) has been running at the rate of 2 million units annually, as opposed to 1.5 million a year ago. Household formation drives both the demand for housing, and the demand for tangible goods to outfit the "new households". New home sales, however, are running at the rate of 500,000 suggesting that pent up demand for homes is building.

The "new jobs" data also suggests support for both housing and consumer spending. The US has been averaging more than 200,000 new jobs per month this year, which are about 100,000 more than is required to absorb the new entrants into the market place. Thus, we are seeing and could be expected to see a continued decline in the unemployment rate as well as the number of people that are only "marginally attached" to the workforce, i.e working part time because they can't get a full time job. The new jobs contribute to increased total consumer income as well as new demand for housing which has been growing at 8%-10% all year.

Expectations for net new jobs are now muted because of the impact of feared bankruptcies in the oil and raw materials sectors. A critical question in all this, is how fast global oil demand will rise (given the new much lower price) to absorb some of the excessive inventories contributing to the price pressures on energy. The irony is that higher prices (whether due to weather or demand) keep marginal producers in production, postponing the ultimate day of reckoning.

Some have raised the spectre of $20/barrel oil: we would be surprised if it got this low as we suspect these are the extreme forecasts that always appear as prices approach a bottom (or a peak) at $30/barrel? But because of the very political nature of the oil price – e.g. the politics surrounding the removal of sanctions from Iran which in turn affects the arrival of substantial new quantities of oil to be sold – we are most reluctant to try to pick the bottom. We just “know” that at $30 a barrel, an awful lot of production becomes untenable for any length of time but producers have proved highly adaptive in this hostile price environment. Thus, we expect somewhat volatile oil prices, and a continued bi-polar investor response as a result.

But at the end of the day, we go back to the idea that there are more consumers than producers of energy and raw materials, and that the losses in the energy sector will be offset by gains in other sectors, e.g. chemicals, airlines, and utilities, etc.

Elsewhere in the US, we see Puerto Rico at the edge of bankruptcy and its first defaults on its debt. It is a complicated situation, that is problematic for those still holding its debt in order to obtain high yields. But while we would expect some elevation of tax exempt bond yields, we don’t see it as spilling over into all municipal bonds to the same degree that mortgage backed bonds hit the bond markets in 2008-2009.

Finally, we come to Federal Reserve Policy: bottom line: they will be cautious and may not raise rates the full 1% over the year as they have suggested in their outlook. Sluggish global growth particularly in the face of bankruptcies in the US energy patch, should keep a lid on rates for a while longer. While we had heretofore anticipated rising unit labor costs by mid-year which are a key to the outlook for inflation, we are encouraged by business investment in machinery and equipment to improve the productivity of labor that will keep (inflationary) unit labor costs at bay.

The Dollar:

The strengthening dollar did a lot of damage in 2015 to the profits of global US companies by reducing the translation of foreign currency earnings back into dollars. But what is important is the change on a year over year basis. In our judgment, the majority of that change has already occurred, and the change in 2016 over 2015 will be relatively modest, perhaps representing less than half the change i.e less than 5% versus an average of a10% rise last year.

Since the Chinese have pegged the renminbi to the dollar, the dollar’s strength has forced the renminbi to rise in value against many of its trading partners, and thus, the Chinese were/are under pressure to lower the peg (devalue) against the dollar to compensate. Devaluation is seen as a way to stimulate growth and employment by many countries. Having said that, we suspect the Chinese may be reluctant to do it again as it speaks of weakness.

China:

Growth in China, as it transitions to a consumer led economy, can be expected to slow somewhat further, but we wonder if we will come to the end of the slow down this year with growth at 6%-7%. It is impossible to tell, but when we see the Chinese government mandating the hiring of terminated soldiers by its state owned enterprises, one can sense that it is very concerned about unemployment, and we would not be surprised to see fiscal measures used to stimulate the economy. After all, it does have the resources to do so, but its sense of timing and urgency is much different than in the West.

Like so many other countries around the world, China has resorted to monetary stimulus first, e.g., the lowering of interest rates, and if the dollar rises further and significantly (we are not convinced on this score – see below) we would expect another devaluation of the renmimbi. Any event that gives hope for faster growth will see a positive response in the stock market both there and here; the opposite will have the reverse affect. Devaluation would again be seen as “fear of further slowdown.” China will continue to give investors bi-polar disease.

Outside the US:

Clearly, those countries dependent on raw material exports, e.g. Brazil, Venezuela, Russia, Australia, and Canada are in or approaching recession. Those countries that are consumers of raw materials are and will benefit from the lower prices, e.g. the US. and Europe, and most (but not all) of Asia and Japan. Our outlook for both Japan and Europe is positive.

However, we would expect Greece to run into problems again as its debt can be expected to approach twice its GDP, a burden that will require a restructuring of its debt, probably by a lowering of interest rates and extension of maturities rather than an outright default and write off. Whether the markets are sufficiently inoculated against Euro-zone break-up fears remains to be seen – but the last round of Greek negotiations suggest that financial markets have already anticipated this problem as well as the solution?

Conclusion:

In conclusion, growth in the US and Europe continues modestly with some improvement in Japan; inflation remains subdued, and markets will react in bi-polar fashion to news that brings hope for greater growth and despair at slower growth. Energy sector bankruptcies will create fear.

Nonetheless, as has been the case for the last 6 years, global growth has continued to creep forward – implying that although it may be slower than normal, it is steady. Unless some event occurs to actually break the momentum, we have long suspected global growth will continue for some time yet because the US Central Bank, and Central Banks generally do not need to curtail activity in the face of rising inflation – which we also think will remain under the Fed's 2% objective. In other words – more of the same!

What to Do?

The implication of the above outlook is that financial markets are likely to trade in a range of plus or minus 10% from current levels until the outlook for growth in China and/or the US changes significantly. The S&P 500, trading at 16 times prospective consensus earnings estimates of $127.00 (reflecting a growth of 8% in profits) is fairly valued in our judgment. (In fact the earnings estimates are probably overstated and the fair value p/e should be higher). Often when the market trades at "fair value", it sells off before rising again. So…….

We are inclined to:

- Keep our cash;
- Use hedges when the year-end rally is over – usually by the 3rd week in January;
- Keep our oils – they insurance against adverse geo-political events in the mid-East, and are too low to sell. Top quality companies should be kept pending bankruptcies of their lesser brethren which should cause the oil price to rise (as production goes out of business). Also, cold winter weather is good for oils!
- In income oriented accounts, use pipelines with little in the way of production assets, to provide income as they have dropped substantially in price for no really good reason.
- Keep our cyclicals on a valuation basis;
- Upgrade our technology holdings to better reflect shifts from old to new technologies;
- Add biotech stocks after Hillary wins the election (this is not a hope, just a judgment call – I am a-political;) or looks like a shoe-in?
- Add selected consumer stocks;
- Use market declines as buying opportunities; and
- Use any sharp market rise to consider sales – we think we have to be more opportunistic this year.
- Add to China, Europe, Brazil and Japan ETF's.

Our reason for being relatively optimistic for the coming year is that much of the news discussed above is already known at least by the professional market place, and we think is priced in already. Furthermore, as we get closer to 2017, the market place will anticipate earnings growth for the next year rising to price in its "great expectations". And if we see China's growth stabilizing (rather than declining), hopes for its expansion will set off a market rally. Given the bearishness of many, we, in our contrarian camp, suspect that in the end, none of the events discussed above will cause permanent damage to financial markets.

David R. Kenerson, Jr.