CMC UPDATE: Stock Markets Enter Correction

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So far, 2016 has not been kind to investors with holdings in stocks or other "higher-risk" asset classes. Since December 16, 2015 when the Federal Reserve increased interest rates for the first time in years, domestic stock indexes have declined over 10%. In fact, earlier today we entered correction territory as the S&P 500 Index at one point was down over 12% from the Fed move. We prefer to focus on the Fed change in rate policy as the "line in the sand" for this discussion as it certainly marked a turning point for the Federal Reserve, and perhaps investor psychology as well. (We prefer not focus on the benchmarks' 52-week highs as these points occurred in the spring to early summer of 2015, and have also been eclipsed by another market correction in the third quarter of 2015.)

So why has market volatility continued into 2016? By no means are we singling out the Fed decision as the sole reason for the market sell-off. In recent quarters we have discussed a wide variety of issues that continued to plague the market and drive negative investor sentiment. These items have included: declining corporate earnings growth, continued slowing global economic growth especially in China, plunging oil prices, persistent geopolitical tensions, terrorism and also concerns over whether the Federal Reserve was correct to raise rates. These concerns have been challenges to the stock market moving higher and also contributed to higher bouts of market volatility for both stocks and bonds.

Lately pressure on the stock market appears to have increased due to rapid declines in oil prices, fears of a hard landing in China, and selling momentum compounded by certain market participants, stop losses, and or margin calls. We will attempt to address concerns around oil prices and China, while leaving market participants' activities simply as a reality of day to day market volume often having little to do with long-term economic and market fundamentals. Oil and China are inter-related, but fears center on each being indicative of broader declines in global economic activity.

In the latter part of 2015 it appeared that oil prices (as measured by West Texas Intermediate or WTI) had started to stabilize in the $40-$50/bbl. range. Despite sharp declines in rig counts, North American oil production has remained high leading to record inventory levels and supply/demand imbalances. Global supplies have also remained high as historical swing producers in OPEC have decided not to cut their production this time around to help stabilize the price of oil. In December 2015, WTI crossed below $40 and has continued to below $27 today as data has showed little change to imbalances. The recent rapid declines have caused rather drastic cuts to market price forecasts to as low as $10/bbl. Historically we have found that when a greater number of market pundits "throw in the towel" it can indicate that the worst may be over, or near over. We are not willing to call a bottom, but it appears we may be getting close and sentiment has gotten extremely negative. However, as we have been saying the global supply/demand imbalance in energy will take some time to work through well into 2016 or longer. It should be said that lower oil prices are positive for many areas of the economy outside of the Energy sector. Case in point is that consumers benefit when they pay less for gasoline, and the hope is that some of those savings translate in to higher levels of consumer spending on other goods and services.

Recent market volatility seems to have focused on a "hard landing" in China. We think this is not likely to occur. China continues on its path of transitioning its economy from infrastructure investments to consumer services. They have made demonstrable progress. This process will also take time, but has already had its impact on commodity prices and manufacturing. The service sector in China has been expanding and contributed the majority of the growth rate in China in 3Q 2015. China's recently reported economic growth of near 7% that has been met with skepticism, with estimates that 4-5% may be more accurate. Even at 4-5% China's economic growth would be twice the growth seen in the US and other developed countries! Policy makers in China have many tools at their disposal to keep the planned transition on its path including monetary and fiscal policy, and structural reform. We think the rapidly declining price of oil is not necessarily a proxy for precipitously slowing economic growth in China.

Unfortunately for investors, as economies are cyclical so are markets. They do not go up forever, nor do they go in a straight line. We would advise investors to try and become more accustomed to higher levels of market volatility as global markets wrestle with changing and divergent interest rate policies, continued slow global economic growth, and commodity-related supply/demand imbalances that may take some time to work through. Although U.S. economic growth has remained slow and below Federal Reserve targets, it has nonetheless been positive. The current economic expansion is growing long by historical comparisons but seems to have legs with positive data from housing, employment, and the consumer in general. The Fed seems to have confirmed that with their change in interest rate policy. At present it also appears to be devoid of most of the traditional signs that a recession may loom on the horizon. Prudent steps like dollar cost averaging into a market declines and taking a lower than typical stock to bond allocation in a portfolios are practical steps investors can take to dampen market volatility rather than be worried about timing the purchase of a stock market bottom.