



## **We are Finally Making Money – Why Does it Feel So Bad?**

The stock market started the year so badly we sent out a piece on January 8, titled “A Bad Start to 2016.” It got worse. On February 11, the market (Standard & Poor’s) hit its low (we hope), down 11% at that point. The market was down almost 15% from its mid-December high.

We advised that you stay the course.

Today, the S&P 500 has recovered and is now up for the year, though not by much. But we have erased those losses. Other markets, like emerging markets and European stocks, have also recovered though to varying degrees.

We sent out a hyperlink to a TV segment I did on March 21 recommending energy stocks. Energy stocks have sizzled since. For example, the Standard & Poor’s energy index has rebounded 22% from its February 11 lows, with most of that gain coming after March 21.

Speaking to clients every day, we get a sense that people are not feeling that good about things. I have to believe that the Presidential campaign is the cause. The negativity has never been worse.

We are advising that you continue to stay the course. There is some good news out there. There is some bad news out there. We worry about the bad news but we think the good news will carry the day, at least for a while. But the bad news will keep us from recommending that investors get aggressive. Think of it as seeing one of those signs while driving on the highway – **Caution: Accident Ahead.**

That’s the executive summary. Here is what we are going to cover in more detail:

- 1) Why we think all of the politicians are wrong on economics
- 2) Why we think we will make money this year
- 3) Why we are proceeding as if there is an accident ahead

### **Populist Politicians**

Populism is the political strategy of giving people what they want in order to get elected; even when you know what you are delivering is bad. It is like giving candy to a child to gain favor. It does not end well. The economic nightmare in Brazil is a very good example.

When first elected, Dilma Rouseff lowered taxes, raised government expenditures and avoided needed reforms. Popular at first, now she is being impeached and has record low approval ratings due to the abysmal state of the Brazilian economy.

We are going to tread very carefully here. We all know that we should not talk politics in a social setting, it does not make for nice conversation. We are going to stick to the economic part of the political debate, and do it carefully at that.

Most people do not have a good grasp of economics. In fact, one might argue that most economists don't have a good grasp of economics given their predictive track record.

But there are two things on which all economists agree:

- 1) Increasing global trade is good for world economics; decreasing trade is bad.
- 2) The only way to grow the collective incomes of a population is by productivity growth.

There is a misperception that the United States has lost millions of jobs because manufacturing has moved to China. Within the misperception is an assumption that manufacturing jobs are better jobs than service jobs. When you reflect on this, it is obviously not necessarily true. How many children are growing up with the dream of landing a manufacturing job?

Even so, the U.S. has lost jobs as China has grown and most of them seem to be manufacturing jobs.

What isn't made in China? In an article titled "Trade, at what price?" by the Economist (April 2, 2016), the magazine contends that manufacturing employment in the U.S. declined from about 17 million jobs to about 13 million over several years. Citing several economists, they calculate that "at most, 188,000 of 484,000 annual manufacturing losses" were because of Chinese imports. Another economist was quoted in the same article estimated that 1m of 5.5m manufacturing jobs were lost to the Chinese. (Note that the total number of manufacturing jobs lost depends on who you ask, but the number is clearly lower than is perceived).

The greater factors were technology, automation and the housing crash which caused an enormous slowdown in building homes. Home building creates manufacturing jobs.

Yet the politicians seem to be unanimous in suggesting that the Chinese are to blame. They suggest erecting tariffs and/or abandoning proposed trade deals. In the early 1930's, trade tariffs started in the United States under the pretense of saving jobs. Inevitably, countries throughout the world implemented their own tariffs, and a recession was turned into the Great Depression. Surely, if we create tariffs, our trade partners will retaliate.

Even abandoning current proposed trade deals is a bad idea. The Transpacific Partnership (TPP) is a trade deal that would benefit the U.S. at least as much as our trading partners. It will create penalties for patent and copyright violations. Such violations victimize U.S. exporters far more than Asian exporters.

There is a direct correlation between global trade and world economic growth. As production moves to more efficient and specialized producers, and as products move freely between countries, the cumulative production of trading partners increases. Increased economic growth and access to more efficiently produced goods increases living standards for all.

While politicians offer many economic “solutions,” including the protectionist strategies just mentioned, no one seems to discuss the only solution that will increase GDP - productivity growth. Productivity growth can occur three ways; more people gets jobs, people work longer hours in existing jobs, or best of all, workers produce more in a given period of time by becoming more efficient.

Productivity growth has virtually disappeared since the turn of the century. During this time, incomes have stagnated or worse. When adjusted for inflation, real wages have decreased. Any discussion of growing living standards should start and end with ideas to increase productivity. Yet we don't hear politicians talking about this.

One cause of the productivity slump is the near collapse in new business formation. New businesses are the drivers of creativity and are job creators. Plans for increasing economic growth must include solutions to the lack of new business creation.

Increasing global trade, increasing productivity and helping to create an environment where people are forming new businesses are not solutions that can be reduced to sound bites. We have enough sound bites, we need problem solvers.

That's as far as we will tread into politics.

### **Continued Profit making in 2016?**

The most disturbing thought about the current stock market is that the bull market started seven years ago. How much longer can it last? This bull market, however, has done something remarkable. It has regenerated itself without stopping. Within the overall U.S. stock market, you will find that most stocks have ended their bull run and started anew again.

That is, most stocks have undergone a bear market of their own, having lost 20% at some point, as measured from a high to a low. Based upon our review, more than three quarters of stocks have experienced a 20% loss or more during the current bull run. By stock market sector, this started with energy stocks in 2014. On average, they declined approximately 50% from October of 2014 to early February 2016. Industrial stocks followed with large declines in 2015. Financial stocks started their decline in the fall of last year. The healthcare sector is currently in its own bear market with the average stock still down over 20% from late 2014 highs.

Maybe the turbulence within portfolios is another reason why this stock market recovery seems so tentative. Our take is that this market demands investors to be in the right sector at the right time. We like energy stocks as they are still in the early stages of recovery within their own bear market. We like some consumer discretionary stocks, like media companies, for the same reason.

We fear consumer defensive and utility stocks as they are near record highs. However, we are reluctant to sell consumer defensive stocks because of their generous dividends and because of the large capital gains that clients have in that sector.

We think that if we can manage the sectors well, we can make money in stocks this year. Typically, only a recession will cause the entire market to fall. We don't think that is going to happen for the following reasons:

- 1) The labor markets are strong as evidenced by continued job gains.
- 2) The dollar has been very strong but has finally weakened this year. A weak dollar helps economies with currencies pegged to the dollar as a weakening currency makes them more competitive. A weak dollar helps economies not pegged to the dollar because their debts are typically denominated in dollars and harder to pay when the dollar is strong.
- 3) The U.S. trade deficit is getting bigger. This supplies trading partners with dollars to spend.
- 4) The price of oil is recovering. When oil was in the 20's, investors feared the repercussions of defaulting oil company loans. Oil is now in the 40's.

Compared to the quarter one year earlier, stocks have posted five consecutive quarters of declining earnings. But much of that was caused by the rout in energy earnings. Because of both recovering energy prices and a slightly better economy, we believe earnings will start growing either by the 2<sup>nd</sup> or 3<sup>rd</sup> quarter of 2016.

### **Warning: Accident Ahead!**

The National Bureau of Statistics of China announced that preliminary estimates of first quarter GDP showed growth of 6.7% year-over-year. This was in line with expectations. Bloomberg noted, "Amid all of Friday's data out of China, one of the biggest surprises was the surge in new credit."

It would not be too much of an oversimplification to say that China is borrowing money to pay for growth. That is something that home owners did with cheap home equity loans in the early 2000's, and we all know how that ended.

The way it is playing out in China is through the state-owned enterprises (SOEs). These are typically companies that are partly privately owned but with the majority of ownership resting with the government. Given the government ownership, the SOEs can lose money year after year without going out of business (not unlike our own U.S. Post Office). The losses are funded by loans from the owner – the government.

The government has the incentive to prevent the company from going out of business because they want growth in the economy. A shuttering of a money losing business would create job losses. The question is, how long can the government keep doing this before the economy crashes?

Gavekal, which provides our economic insights, produced four pieces on China in their March China Economic Quarterly<sup>1</sup> ominously titled as follows, with subtitles:

**Powerhouse, Menace or the Next Japan?**

**China's Impending Minsky Moment.** China's authorities have given up on trying to solve the country's spiraling debt problem. A financial crisis and severe growth downturn are likely by 2020.

**The Fall of Productivity and the Rise of Debt.** Despite rising debts and falling capital productivity, strong state enterprise reforms could allow economic growth to stabilize at a high level.

**Excess Capacity, Zombie Companies and Debt Deflation.** China's zombie company problems are mainly confined to its steel, coal, and other construction-related industries. A long, slow restructuring is possible.

The conclusion is clear to us – China needs to reform its SOEs, or else.

The Economist put it like this:

“Since last year, he (President Xi Jinping) has begun to talk of a need for ‘supply-side’ reforms, implying that inefficient, debt-laden and overstaffed SOEs (ie, most of them) need shaking up. But his approach has been marked by uncertainty, U-turns, and occasionally, incompetence.”

Further, they wrote that “the reform of SOEs has barely begun, stymied by the vested interests of SOE managers and their political friends, by fear of increasing unemployment, and perhaps by Mr. Xi's own oft-stated belief that the party should keep its hold on the main economic levers.”<sup>2</sup>

And on April 16, the Financial Times ran an article titled “Chinese SOE bond defaults stoke fears.”<sup>3</sup>

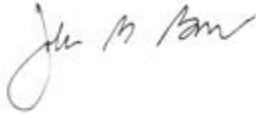
Recessions and bear markets do not begin simply because the recovery and bull market has gotten old. There are cycles and at the later stages of cycles, excesses develop. The bigger the excess, the bigger the problem. We think you are going to hear a lot more about the Chinese SOE problem, but we remain convinced that the Chinese have the savings stock pile to push off the day of reckoning for a while.

For now, we are telling clients that the world economy should expand at a slightly higher rate than last year, helping earnings increase slightly and resulting in small gains in the stock market this year. But we are very concerned about the politics here and the problem with the Chinese SOEs.

We remain vigilant, but once again, are advising that you stay the course.

May 9, 2016

Sincerely,



John B. Burke, MS, CFP®  
President, BFS

<sup>1</sup>Gavekal China Economic Quarterly, March 2016. Articles by Arthur Kroeber, Jonathan Anderson, Richard Herd and the last by Thomas Gatley and Rosealea Yao

<sup>2</sup>The Economist, China Trouble, April 2, 2008, pp 46

<sup>3</sup>Financial Times, Chinese SOE bond defaults stoke fears, April 16, 2008, pp 22

*The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The S&P 500® Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector. Keep in mind that individuals cannot invest directly in any index. Dividends are not guaranteed and must be authorized by the company's board of directors. The information contained in this report does not purport to be a complete description of the securities, markets, or developments referred to in this material. The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete, it is not a statement of all available data necessary for making an investment decision, and it does not constitute a recommendation. Any opinions are those of John B. Burke and not necessarily those of Raymond James. Investing involves risk and you may incur a profit or loss regardless of strategy selected. Past performance may not be indicative of future results.*