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VIEWS FROM CAMELBACK MOUNTAIN

Perspective on the Chinese Stock Market Crisis

So far, 2016 is not off to a good start for global financial markets. It is clear that the market declines and volatility are being caused by a global reaction to the economic problems in China. A specific problem relates to the recently enacted trading restrictions in Chinese stocks. Starting January 4, 2016, China created "circuit breakers" that halt stock trading for 15 minutes any time their markets decline 5% or more. After the 15 minute timeout, if the markets fall another 2% or are down 7% for the day, the market closes for the remainder of the day. China clearly wants to stabilize their stock markets and reduce the day-to-day gyrations. Unfortunately, the new trading regulations have actually created a stampede of sellers that are eager to get out before the markets close for the day. The Chinese stock markets were down 7% on Monday, January 4 and were down another 7% on Thursday, January 7. On Thursday, it only took 30 minutes for the markets to close for the day. Fortunately, after trading on January 7, the Chinese government suspended these "circuit breakers". The problem with this policy is that the level of the decline that triggers the trading halts is too small given the volatility of the Chinese markets. These regulations were foolish and almost certain to create the volatility and weakness that they were designed to prevent.

Moving to U.S. markets, we experienced a market correction in August 2015 that resulted in a decline from the previous peak of 13% -14% for broad U.S. indices. The U.S. market rapidly recovered in October and closed out the year down slightly. The August decline coincided with a break in the Chinese stock markets, and was triggered in part by their government allowing the Chinese yuan to devalue. As we have been writing to you for some time, we were not convinced that the August weakness was over and we were concerned that weakness in China may cause further short term damage here in the U.S. markets.

The link between the Chinese markets and U.S. markets centers around slowing growth in China, causing weaker demand for oil and other commodities, which in turn have caused dramatic declines in commodity prices. Weakness in China is causing investors to expect slower global growth, which directionally is not a help for the U.S. economy and our businesses. Slowing growth in China and weaker commodity prices have also increased the value of the U.S. dollar. This has caused further weakness for U.S. manufacturers and industrial companies, particularly those that export products from the United States to global markets. Finally, some American companies have significant exposure since they sell many of their goods in China. Obviously, if demand weakens, this will hurt the prospects for U.S. companies that have large businesses in China.

We continue to believe that the U.S. economy is likely to grow in the 2.0% - 2.5% range as measured by the GDP in 2016 and likely in 2017. We do not think that the weakness in China or even global weakness that is due to China's economic issues will cause enough damage to the U.S. economy to push it into a recession. These factors will not help U.S. growth, but we do not believe it is enough to extinguish U.S. economic growth. We continue to expect most American companies to show fair to moderate growth in earnings, dividends and cash flow this year. We also think U.S. stocks are roughly fairly priced given growth prospects, interest rates, inflation and other variables that influence stock prices. As a result, we think we are once again experiencing a normal correction that markets typically encounter every year or two. We suspect that this is a continuation of the correction that started in August 2015.

The market low in August was approximately 15,660 on the Dow Jones Industrial Average (DOW) and it would not shock us to see the markets decline to approximately that level in the near term. Longer term, we think investors will begin to understand that the difficulties in China are unlikely to derail U.S. economic growth. If we are right, the U.S. markets should recover relatively soon (over the next few quarters). We continue to anticipate a relatively modest, but profitable year for the U.S. markets.

We also think it is important to gauge the likely behavior of the Federal Reserve's reaction to these market disruptions. While we are not fans of the current Federal Reserve Board or their behavior over the last several years, we think it is relatively easy to anticipate their behavior. If the current weakness continues and possibly drives the DOW down another 1,000 points or so, we can't imagine that this Federal Reserve will raise interest rates in the near term in that environment even if unemployment declines and inflation gradually picks up. A passive Fed would probably soothe troubled financial markets. Later on this year we still expect the Fed to increase interest rates some.

At this point, we are not suggesting that our clients sell stocks. We think a fair amount of the market damage has already occurred. We think it is unlikely that the U.S. markets will drop dramatically or that the declines will be long lasting. We do expect China to enact additional changes to trading, which should stabilize their markets to some degree. It may make sense to consider some adjustments in individual portfolios to further reduce even indirect exposure to China.

It is obviously upsetting to watch the volatility and weakness in the U.S. markets. It may well persist for another few months. We think the real damage is limited to Chinese stocks, which appear to have been severely overvalued and caught up by wild enthusiasm from many Chinese investors with very limited experience and perspective. If you own established stocks in solid, high quality companies with consistent businesses, such as we have in our portfolios, we think it is best to ride out the storm. If you have exposure to emerging markets or China directly, it might be wise to make some adjustments.

We will keep you posted as market conditions develop. Please give us a call if you have any questions.

Best regards,

Harry Papp
Managing Partner
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