Fairport Perspectives

January 13, 2016

Here are our thoughts on navigating a rocky start to this New Year.

The equity markets finished 2015 on a negative note after peaking intraday on May 20th at 2,134 for the S&P 500 Index. After the high in May, the S&P 500 Index experienced its first decline of 10% or more in over 4 years with a peak to trough fall of -12.5% in August of last year. Since then we have seen an increase in volatility and swings in market direction both domestically and overseas. With the first week of 2016 in the books, we have seen the S&P 500 Index decline -5.91%, the more global benchmark MSCI All Country Index (ACWI) fall -6.13% and the small cap Russell 2000 Index pullback -7.88%.

Most of the declines in the first week of the year can be attributed to the uncertainty in both the Chinese economy and the direction of their equity markets. Last week the Shanghai Composite Index, a benchmark for Chinese equities, declined -9.97% on concerns the government will continue to devalue the local Chinese currency, the Yuan, versus foreign currencies (mainly the U.S. Dollar). Cornerstone Macro is forecasting the Chinese economy to slow to 5.0% GDP growth in 2016, much lower than the 7.0% expected by the government in 2015. The stock market in China closed early twice last week after triggering circuit breakers, a procedure to stop trading after a decline of -7%. Further devaluing of the currency can be expected in early 2016, paired with more monetary and fiscal stimulus.

Domestically, the market most likely overreacted to the developments in China. Research firm Evercore ISI does not see a hard landing in China in 2016 but does see more government intervention to help prop up the economy. However, the technical view of the market has soured in the last few weeks and could be forecasting more downside in the coming weeks or months. The 50 day moving average on the S&P 500 will likely fall below the 200 day in the coming days to form another "death cross", pointing to muted returns in the next few months. RenMac, a leading technical research firm, is forecasting a retest of the August lows of 1,867. Sentiment, as measured by the percentage of investors who are bullish, on the other hand is close to lows not seen since 2011 per Ned Davis Research. This has been a good contrarian indicator that the market could see a bounce in the next few days/weeks.

From a macroeconomic standpoint, the U.S. economy remains on firm ground. The economic expansion is slow but solid and the likelihood of a recession in the near future remains low. The economy created over 300,000 jobs in the recently reported month of December. The unemployment rate remains steady at 5% and weekly claims for unemployment are at 40 year lows. Wages have begun to increase and inflation is well in check. Consumers continue to pay down debt and gas prices should remain low as oil breaks to new lows in the past few days.

Longer term, market fundamentals remain in good shape. Fourth quarter earnings will kick off later this week, taking the focus off China. Price to earnings (P/E) multiples remain near long term averages and could see some improvement as better economic numbers are reported in the coming weeks. 2016 will be key to earnings growth, with Baseline predicting growth of approximately 6% in the next 12 months. The year-over-year comparison should be better as the drag from the dollar eases in 2016. We still view equities attractive relative to fixed income as the Fed most likely will raise rates 3 to 4 times in the New Year.

Globally, indicators are pointing to better growth in both Europe and Japan in the coming months. Both regions continue to provide monetary stimulus from their respective central banks and should see more not less support in 2016. Currencies will play a big role in returns with both expected to see some weakening in the future.

It is our opinion that we remain in the secular bull market that began back in March of 2009 and should continue for several years to come. Ned Davis Research has pointed out that years with flat returns (5% or less) in secular bull markets are followed by strong years with a median return of 18.6. While we will see pullback along the way, we remain constructive on the global equity markets and remain invested per our asset allocations. Our team is constantly monitoring current events and analyzing how we believe they will affect your portfolio. As always, please feel free to contact us if you have any questions, comments or concerns.

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