Green Investment Management, Inc.

309 W 7th Street • Suite 101 • Fort Worth, Texas 76102-6901
Toll Free (800) 950-8004 • www.GIMLink.com

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Market Commentary

The 2016 State of the Markets Address

Friends, clients and fellow investors, I am here to report to you the state of the markets at a most interesting time in history, one fraught with great dangers, but equally filled with great opportunities.

Stocks around the globe, in both developed and emerging nations, are undergoing a disquieting correction. The S&P 500 is down some 8% since the start of the year. We saw similar market jitters last August, and it proved temporary. Now we must face the question of whether this new turbulence portends more serious and lasting trouble, or is simply the ephemeral volatility of angst. We must ask ourselves: What are the sources of investor concern?

One source of concern is interest rates. Expectations of an interest rate hike contributed greatly to volatility in 2015. The Federal Reserve finally increased short-term interest rates by ¼% on December 16. It was the first hike in nine years. And now investors wonder how fast rates will rise and whether this threatens the recovery.

But consider the full picture. The Fed's decision to raise rates came from the organization's collective view that the U.S. economy is strong enough to continue growing even as liquidity is reined in. And further Fed action will be gradual and dependent on developments in the U.S. and global economies. While there may be more Fed rate increases in 2016, that by no means necessitates a downturn in the business cycle. A recent analysis of the last four business cycles in the Federal Reserve Bank of St. Louis Review found that, historically speaking, an economy can continue to grow well after rate increases begin.

Another source of concern comes from China. Investors worry about the possibility of an acceleration in the economic slowdown there and rising currency volatility.

But consider the full picture. Only three years ago, after decades of extraordinary growth, China became the largest manufacturing economy on the planet. The nation imported equipment and raw materials to produce goods to export to the world. Eventually this growth model reached its limits. Centrally based, ideologically-driven economic targets created much excess capacity. Slower growth in export markets such as the U.S. and Europe compounded the problem. State owned enterprises amassed debt at an alarming rate. The outline of these problems was recognizable when China's ruling party met in late 2013. So they began an effort to make future growth more consumer-driven and to curtail the rapid growth of debt.

It is a difficult transition, but there has already been some success. The services side of the Chinese economy has grown to represent 51% of GDP, while the industrial sector's share has shrunk to 40%. This is a monumental shift for such a large economy to make in a relatively short span of time. Overall, China's growth remains relatively healthy, considering these changes. The official GDP growth rate is currently 6.9%, though other estimates generally put it a percent or two lower. We are unlikely to see the double digit rates we were once accustomed to from this emerging giant. But a more balanced economy should lead to more stable and sustainable growth. In the meantime, the slowdown is adding to global volatility. But looking out a year or so, a recession in China does not appear likely in my opinion.

Another source of concern is the slide in oil prices. In fact, recently the price of oil seems to be giving directional cues to both the S&P 500 and high-yield bonds. The environment is even more challenging than prior energy gluts in 1986, 1998 and 2008. The sector is single-handedly responsible for most of the disappointing composite earnings that the S&P 500 produced in 2015.

But consider the full picture. With some stabilization in oil prices in the months ahead, earnings could improve as we move through 2016. Energy companies across the globe are cutting both expenses and drilling budgets. This should eventually bring supply and demand back into balance. That said, we may see more fallout from weak energy and commodity prices in the immediate months ahead. And this may keep markets on edge. But a wider credit crisis or recession do not seem especially likely. And I think we are approaching the end game in terms of balancing supply with demand. When that happens, we should see renewed confidence in owning stocks, especially energy stocks whose valuations by some measures are at historic lows. And we shouldn't forget the ever-present geopolitical turmoil in the Middle East, which always brings the threat of disrupted supply and higher oil prices. One counterpoint to mention here is that growing hostility between Saudi Arabia and Iran reduces the likelihood of OPEC oil production cutback agreements. This could work to extend the oil price slide longer than would otherwise be the case.

Another source of concern is that without the tailwind of monetary accommodation from the Federal Reserve, U.S. equity gains will depend on earnings growth. And until we see improvement in earnings, it will be difficult for U.S. stocks to make stable progress. But U.S. companies are facing headwinds in their efforts to grow earnings. New wage growth that threatens profit margins is one headwind. A stronger dollar is another. In fact, up some 23% in the last 18 months, the dollar has already harmed the profits of U.S. exporters.

But consider the full picture. Exports account for only 13% of U.S. GDP, while consumers account for over 65%. These are the same consumers who benefit from both cheap oil and a strong dollar.

Yet another source of concern is the uneven nature of this recovery. Since the Great Recession, there have been ebbs and flows from quarter-to-quarter and even month-to-month. Good data followed by bad followed by good has become almost the norm. One of the few consistent trends is a declining labor force participation rate. All of this creates the worry that our expansion may be happening on precarious ground.

But consider the full picture. Demographics help explain labor force participation problems. And while that will continue to play out, actual jobs data remains strong of late. Last week's nonfarm payroll report for December showed non-farm jobs growth of 292,000, well above expectations.

Now, having discussed my overall view of the state of the markets, I would like to take a few moments to frame an agenda going forward. It's a bold agenda, but one we can pursue with caution as 2016 unfolds.

With regard to U.S. stocks, we are proceeding at market weight. Recent weakness is presenting some excellent opportunities to acquire issues at a discount to year-end values. While the most substantial equity gains in this business cycle may be behind us (P/E levels are 14.7 times forward Factset estimates), I still anticipate positive returns in 2016, ones driven by earnings. But volatility could be significant as well.

With regard to international (developed nation) equities, we are proceeding overweight. In particular, Europe and Japan are attractive due to valuations still well below past peaks. Continuing central bank stimulus, currency weakness and falling energy prices should provide additional tailwinds to those markets.

With regard to emerging markets, we are proceeding modestly underweight to market weight. Most emerging markets are trading at discounts to historical averages. But headwinds from rising U.S. interest rates and currency weakness against the dollar may continue to pressure this asset class in the months ahead. Nonetheless, I still see attractive entry points based on valuations that are the best they have been relative to developed markets in over a decade. But it requires selectivity, with Mexico and India among a list of countries having some of the most favorable dynamics right now.

With regard to domestic bonds, I expect yields to eventually pick up as the year progresses. While rising rates may make for a challenging environment, the demand for income from institutions and aging baby boomers will play an offsetting role to some extent. Inflation protected TIPS (slight overweight) are a good option to pair with nominal Treasuries (slight underweight) as a hedge against inflation surprises. Wider credit spreads offer reward for risk, but negative outflows are raising liquidity concerns in the high-yield space, in spite of attractive valuations. On balance, we proceed underweight on high yields at present. But we remain prepared to change quickly in this space as opportunities present.

Finally, with regard to commodities, they remain very sensitive to the dollar's strength. And we expect the dollar to remain strong in 2016, although advances should be more modest. Overcapacity continues to be a problem in much of the commodity complex. But adjustments are taking place that should eventually bring attractive return opportunities. This will be especially true if inflation ticks up in the U.S. as expected.

In closing, and in case you haven't noticed, my approach to this month's update has been somewhat modeled on the State of the Union addresses that U.S. presidents since George Washington have made in front of Congress, and which are actually called for by the U.S. Constitution. It is meant in a spirit of fun, and not to trivialize either the office of the president or our investment portfolios. Hopefully you can take it as such, and we can all proceed into 2016 with a renewed sense of purpose, not as Republicans and Democrats, or bulls and bears, but as investors united in providing for our families' wants, needs and dreams of the future. Thank you and God bless.