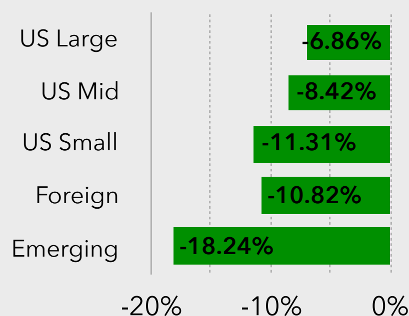
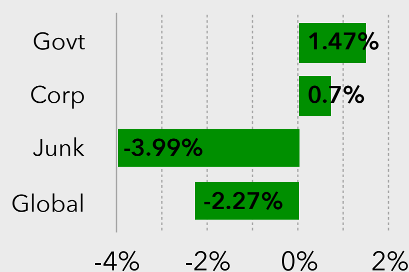
Economic Data

- 2Q GDP grew at a 3.9% annualized rate thanks to a strong consumer
- Year over Year Inflation (CPI) was 0.2% for August
- Retail Sales were up 0.2% in August
- 523,000 jobs were added during the quarter and the unemployment rate dropped to 5.1%

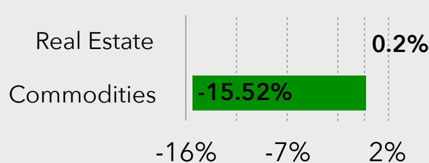
Stocks



Bonds



Alternatives



Above index data provided by Morningstar.

Correction Territory

You might recall (probably not) that in the closing paragraph of my first quarter newsletter I made mention of market corrections and how we were long overdue for one. Well, we finally got one. What is a market correction, you might ask? It's a very pleasant euphemism we use in the investment world for when the stock market declines by 10% or more from a recent high. "Correction" sounds a lot better than "getting your ass handed to you", doesn't it? Kind of like calling it a "rescue" instead of a "free dog", or when a millennial says "roommates" instead of "parents".

Corrections really aren't so bad, though, and often they are quite healthy for the market. On average, they happen almost once per year, but we hadn't seen one since August 2011 when the sovereign debt crisis was at its peak and U.S. government debt was downgraded by S&P for the first time in history. That ended up being a -19.4% correction from peak to trough, but markets gained all that back in the next five months and continued their bull run to gain a further 56%, topping out in May of this year. And just like the last one, I don't think this one is a harbinger for a prolonged bear market, but rather an attractive opportunity to buy.

Market corrections are a lot like when a fire alarm goes off at a school and everybody rushes to flee the building. Meanwhile, the firefighters rush in to assess the situation. Sometimes there is a real threat, but far more often some emo kid just pulled the alarm.

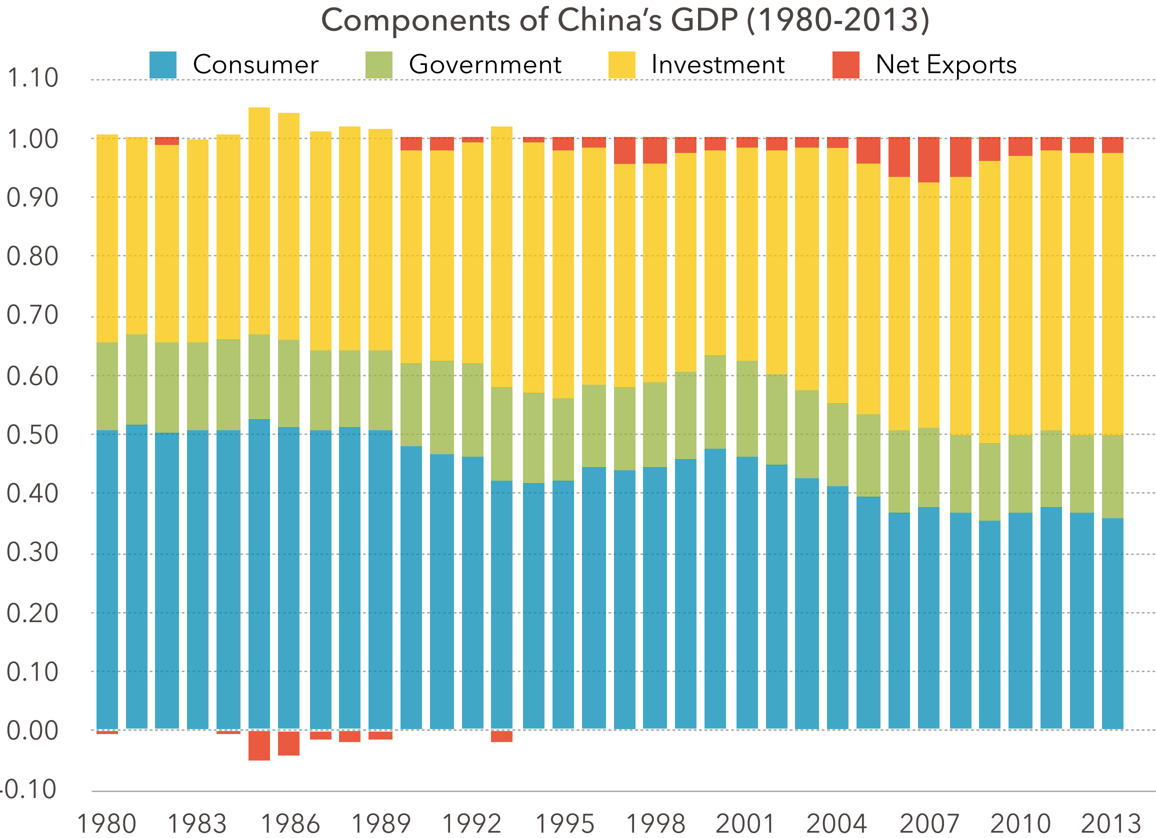
That Prank We Pulled at Traffic Lights as Teenagers

I thought "Chinese Fire Drill" would have been a great title here, but I Googled it and apparently *Chinese* is used as a pejorative in the phrase and therefore it wouldn't be P.C., and I've been P.C. for about two weeks now. Instead, let's just say the stock market stopped at a red light and a bunch of people got out in a mad panic… because of China… and they now need to get back in the market before the light turns green.

So what's going on in China that has everybody so worried? In last quarter's newsletter I warned that China was the country we should be worried about, not Greece. The Chinese stock market was red-hot with the Shanghai Composite up 54% for the year before things turned south very quickly in June. The composite proceeded to lose almost one-third of its value over the next four weeks or so, but this had little affect on U.S. markets which remained stable. This is indicative of a global equity market that is becoming less correlated, which adds credence to the benefits of diversification.

China devalued the yuan on August 11, which got investors' attention, but they didn't start to panic until a flash reading of the Markit purchasing manager's index (PMI) fell to 47.1 – its lowest level in six years. Any PMI reading below 50 indicates a decline in manufacturing activity. This stoked fears of a hard landing for China's economy, and global markets sold off in startling fashion.

China certainly does have some problems, including declining corporate profits, weakening employment, and excessive inventories. These are going to continue to put pressure on economic activity. They want to transition from an export- and investment-driven economy to a consumer-driven economy. Household consumption makes up about 69% of the U.S. economy, but in China it represents only 36%. For them, capital formation (investment) makes up the the largest chunk of the economy at about 48% (this is only 19% in the U.S.). Capital formation includes net changes to inventories of goods as well as fixed assets, which include improvements to land, purchases of machinery and equipment, and construction of factories, houses, schools, and infrastructure like railroads and highways.



China has been investing heavily in infrastructure for decades now, helping to fuel economic growth. But you can only build so many highways, factories, and Bird's Nests and Water Cubes before the marginal benefits start to rapidly decline. Take expressways, for example. In 1988, the Chinese first proposed the National Trunk Highway System with a goal of expanding their expressway infrastructure from a paltry 147 kilometers to 35,000 kilometers by 2020. The original goal was achieved 13 years ahead of schedule, so they increased it to 85,000. That new target was hit in 2011 – nine years ahead of schedule – at which time China surpassed the U.S. interstate system in length to become the largest expressway system in the world. At the end of 2014 the total length stood at 111,950 kilometers, compared to 77,017 for the U.S. China has essentially the same land area as the U.S., and as of last year about 86 million *fewer* automobiles. The dishes are done, man.

The decades of double-digit growth in China fueled by investment are over, and the transition to a consumer-based economy will be a long one. China reported 2nd quarter GDP growth of 7.0%, but it's difficult to take

the numbers they report at face value as they like to smooth them out. Economists' estimates vary on what the real number is: 6.0%, 4.9%, 4.0%, 3.8%? It's likely a point or two below what they are reporting. Still, 5 or 6% growth is better than what we have going on. There is a big difference between slowing growth and a recession.

On top of that, the U.S. isn't as closely tied to China as some might think. We might buy a lot of stuff from them, but we don't sell much to them and for once that's not such a bad thing. Exports to China so far this year only represent about 0.65% of our GDP. Europe, Canada, and Mexico are each far more important to our economy than China. The reality is total exports only represent about 13% or our economy. Much of the rest of the world struggles when we do, but it doesn't necessarily work both ways.

Boom City

The shale boom here in the U.S. has created a glut of oil supply, and OPEC has refused to cut production in an attempt to maintain their market share which is why prices have been so low. Fears over China's slowing growth — and therefore slowing demand for oil — sent the already beaten-down oil market crashing to around $38 per barrel on August 24; the lowest level in over six years. Prices quickly rebounded, though, and have been stabilizing around $45 for the past month.

U.S. oil stockpiles remain about 100 million barrels above their five-year average, but production is finally declining as many oil producers have idled rigs in response to the lower prices. The lower oil prices hurt economies of oil-exporting countries like Venezuela, Russia, and Saudi Arabia, but they are a huge benefit for net consumers of energy like the U.S. and even China.

The U.S. consumer is feeling good right now, and it is coming through in the economic data with 2nd quarter GDP growth at a solid 3.9%. Spending at restaurants has increased 8% over the past year, and that is a huge sign of short-term confidence. People are taking that extra money they would've put in their gas tanks and instead plowing it into unlimited soup, salad, and breadsticks. Automobile sales are running at a rate of about 1 million more than last year. People — well, smart people — don't take on the extra debt tied to a new car purchase if they are uncertain about the security of their job. Lastly, there isn't a much bigger indication of confidence than purchasing a new home, and in August new home sales hit their highest levels since February of 2008.

Fed Up

Despite all the good economic data, the Fed decided not to act at their September meeting. It was clear from Janet Yellen's speech following the decision not to raise interest rates that trouble in China was a big factor. "Heightened concerns about growth in China and other emerging market economies have led to notable volatility in financial markets," Yellen said. And many people — even some inside the Fed — publicly criticized the move. It signaled to the investing public that maybe something was wrong after all, even though unemployment is low and the U.S. economy has been humming along. And just like that, a market that had already clawed its way half-way back to its high-water mark fell right back down again.

A week later, her tune changed a bit in a speech at U-Mass Amherst. Instead of focusing on global issues, she pointed to persistently low inflation as a justification for keeping rates at zero. But near-zero inflation had been primarily driven be lower energy costs — a good thing — while the core inflation rate has been 1.8% over the past year. The speech ended with a bit of a health scare as Janet Yellen struggled with two very long pauses where she froze on stage. But don't worry about J-Yells; she is fine now and chalked it up to nothing more than dehydration after what must have been a very stressful week. I think the best cure for what ails her would be to finally raise the damn rates! Again, exports are only 13% of our GDP. The Fed should have been focused on

domestic conditions, not foreign ones. Unfortunately, with a ho-hum September jobs report just released on Friday the window may have passed. Now the market isn't expecting a rate hike until March.

Portfolio Positioning

While the stock market is feeling uneasy at the moment, it doesn't take long for investor sentiment to swing. It's one of the few arenas where if you ignore a problem long enough, it will actually go away. On August 24 after the market plunged at the open, we went into all of our wealth management client accounts and trimmed bonds and alternative investments and used the proceeds to add to stocks. We expect a cyclical recovery in stocks over the coming months, and this positions us to take advantage of it.

Stay rational; time will smooth things out.

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