

B A R R E T T

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Market Update – August 31, 2015

Since last week the U.S. stock market has declined sharply on the throes of more substantial declines in the Chinese markets.

What is going on?

When a country like China that has been so important to global economic growth over many years suddenly starts to slow significantly, it has ramifications around the globe.

The latest news from China:

- On August 7, China reported surprisingly negative export and import data suggesting that their economy is slowing at a faster rate than previously anticipated.
- On August 11, China devalued its currency, which led many investors to conclude that China's leaders foresee a worsening economy.

These two events followed other negative trends that had developed over the summer:

- United Technologies, which has a large construction-related business in China, reported in July that orders for their elevators declined 10% and not the 5% gain they had expected earlier in the year.
- United Technologies was not alone. Other U.S. multinational companies, particularly technology companies, referenced an even steeper drop off in their China business.
- Also, since June the Chinese stock market was in the grips of a stunning decline after an equally stunning rise earlier in the year. When Chinese authorities made a clumsy attempt to arrest the decline, global investors were unhinged by their financially unsophisticated measures.
- Chinese retail investors were left holding the proverbial bag, which was another blow to confidence in their leaders as well as their personal finances.

The U.S. stock market finally started to crack last week and on this Monday the dam broke and stocks cascaded down.

So, how do we think markets will do going forward?

After Tuesday's close the S&P 500 was down 9%. For several years we have been expecting modest positive returns in the market, so a near double-digit decline would be a surprise if it holds through year end.

The reasons we have expected positive and not negative returns would include:

- The U.S. economy is in a solid, but subdued economic recovery, and Europe's economy has stabilized.
- Interest rates remain low, thereby enhancing the attractiveness of stock dividends.
- Valuations were above normal, but not so high as to cause a broad selloff. Certainly we have pointed to specific areas of overvaluation, and we have seen declines in those stocks.
- We continue to think the U.S. stock market can post positive returns over the next year, but there are more headwinds entering 2016 than in the past few years. These additional headwinds would include the possibility of higher interest rates, soft global growth, and political uncertainty at home.

Does the greater weakness in China, the rout in commodity prices (particularly in oil), and the decline in currencies of heavily indebted emerging markets change our strategy in any way?

To some extent, the answer is yes:

- We are making sure that our portfolios do not have exposure to the overbuilding and excess capacity that has developed in China.
- We remain willing to have exposure to China's consumer markets, but will take a measured approach with the view that over the long term China will transition to a consumer driven economy.
- We think it will take time for most commodity prices to recover due to a prolonged period of weak China demand. Therefore, emerging economies will be challenged.
- Oil prices are harder to predict. The Saudis may want to continue to pressure our U.S. shale companies as well as inflict more pain on Russia and Iran. But, with budget pressures increasing in the Middle East, this gambit is likely closer to an end. We are holding energy positions at this time, but may employ some tax driven changes.

In the meantime, we have taken losses where it has made sense for taxable accounts and raised some cash to take advantage of future buying opportunities. We are always available to add more commentary, and welcome any questions that you may have.

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