October 1, 2015

Greetings,

The stock market is in the midst of the long awaited 10% "correction". Corrections are normal. Historically, over a 20 year period, these corrections happen on average every year and a half. Doing the math, what is happening now should be expected to happen 13 times over the next 20 years. Shortening the time horizon, these corrections should happen 3 times every 5 years. The market has basically gone straight up the past 4 years. That was far from normal.

The crazy thing about corrections is that not only is it impossible to predict when it will happen, but virtually no one knows why it occurs until after it has already occurred. It is like the weather forecasters who did a great job explaining after the fact why they couldn't predict why the weekend was rained out. Much of the chatter now is about China's "woes" and the slowdown of its economy. I have been listening to all the chatter about the fears of a China slowdown or a "hard landing" for so long, it is difficult to remember and my memory is pretty darn good. China's economic rate of growth has decreased by at least 30% over the past six years, yet the domestic (U.S) stock market has done fantastic over that same time period. If I was invested in the Chinese stock market, I would sure be concerned. China's economic rate of growth is so strong (approximately 7% annualized) it is inevitable for the rate to continue to slow. We should only have China's problems. Out of intellectual curiosity, I did some research to see if the U.S economy had growth rates equal to or greater than China's now. You have to go way, way back to the go- go years of the late 1980's, during the Reagan era when there was a sugar high from all the tax cuts AND spending increases. FYI, it is not that difficult to have some serious economic growth if you drastically cut taxes AND increase government spending simultaneously. Keep in mind that exceptional rate of growth was just for one year, 1987. The Chinese economy has been doing this every year for a while, other than 2008. Yet so many people are nervous about China's rate of economic growth slowing to 7% and probably continuing to go lower over time. The uncertainty is how much lower and how quickly the rate of growth slows down.

There was a great article in the Wall Street Journal a few weeks ago concerning China's economy. The headline was "China woes could be good for the U.S. economy". The article pointed out how the slowdown in China's rate of growth could benefit the U.S. economy. One of the highlights was how the article pointed out that weak demand in China would continue to depress the price of commodities such as copper, oil and steel used in cars, electronics and other consumer favorites. Another plus: big Chinese firms would likely invest more in the U.S. as returns on investment shrink in China and expand in the U.S. Also of note is the U.S. economy isn't all that closely tied to China. The financial media gives this impression but the facts prove otherwise. U.S. exports to China are about 1% of American GDP. U.S. GDP for the second quarter was just revised up to an annualized growth rate of 3.9%. Much of this is a snap back from the slow first

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quarter, partially because of the tough winter. However, the strong second quarter number is a clear indication that the U.S. economy has not been affected by China. If anything, lower energy prices are finally starting to have a positive effect as the restaurant business is showing some nice top line increases as are retail sales. The auto industry is also showing record sales numbers. You wouldn't know it from the stock prices but fundamentally, the industry is strong. During the market lows in mid-August, Tim Cook (the CEO of Apple) did an interview with James Cramer (of CNBC) to discuss the strength of IPhone sales in China this quarter. Again, you wouldn't know it from the stock price of Apple but this is exactly why the prices of stocks truly defy logic in the short term. Just last week, Nike reported a blowout earnings report and get this, Nike cited "strength" in China. In a nutshell, the empirical evidence from the companies doing business in China contradict the macroeconomic headlines.

Speaking of headlines, the Fed has been in the news again. Two weeks ago, at their last meeting the Fed decided to keep short term interest rates where they are, at near zero. Leading up to the meeting, it appeared that the worst of this stock market "correction" was over. Not so fast. Most economists were expecting the Fed to pause. I would estimate that more than half of the stock market observers (and participants) were hoping the Fed would finally pull the trigger and begin raising rates. I can't speak for others but from my point of view, enough is enough already. The reason being we have reached a point of diminishing returns as far as near zero short term interest rates. More importantly, the Fed has put themselves into a box for the December meeting. It is extremely unlikely (although possible) that the Fed raises rates in late October since there is no press conference after that meeting. That means they pretty much have to raise rates in December because if they don't, then they lost all credibility since Janet Yellen has been saying all along that rates would start going up this year. If the Fed would have started raising rates at the September meeting, then they could have had some cover in case they wanted to pause in December, for whatever reason. That was what the market (along with myself) wanted. When the market doesn't' get what it wants, then it throws a temper tantrum by selling stocks, regardless of fundamentals and valuations. In the two weeks since the last Fed meeting, the broad market is down 3%. That is a heck of a drop in just two weeks. My view is that if rates would have increased by just ¼ of 1%, then the market would have seen that the Fed had confidence that the economy could handle a rate increase. By leaving rates alone, the Fed made a statement that they were concerned about global economic growth and that spooked the markets. Some people are concerned that if the economy can't handle a small ¼ of 1% increase, then the economy could be in worse shape than it appears to be. I am not in that camp. I think the economy can easily handle a ¼ of 1% increase in short terms rates. Janet Yellen has made it clear that short term rates will go up at a snail's pace. That term is me paraphrasing what she said, which was "gradual". I wouldn't be surprised if short term rates only rise 2-3 times next year. That would leave the Federal funds rate at a ridiculously low rate of either 1 or 1 ¼% at December 2016. The slow global growth and low energy prices (in my view, they will go even lower once the Iran oil hits the global markets later in the fall) are giving Janet Yellen plenty of cover to raise rates as gradually as she wants to next year. In all due respect to the Federal Reserve chairwoman, Janet Yellen made a big mistake at the last meeting and at this point in time, I think that she knows it.