DÉJÀ VU

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INTRODUCTION

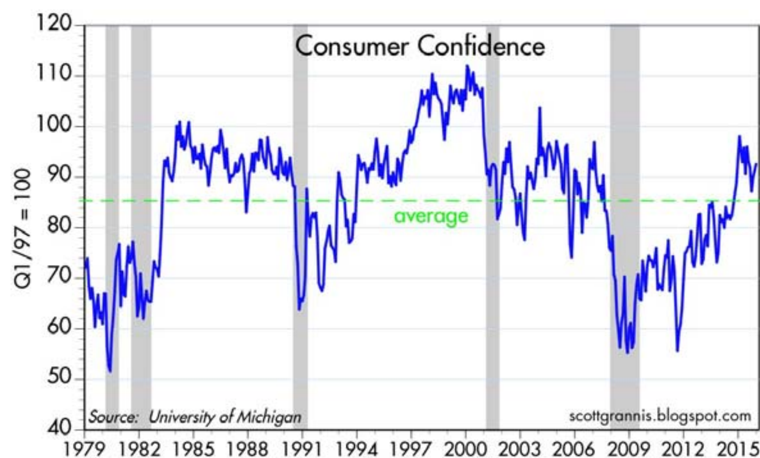
Here we are in a New Year staring into our crystal ball to forecast future events in global financial markets…along with thousands of other investment professionals, economists and market pundits. Before we do that, let's take a look at how successful we have been with our predictions for last year. A few of our investment themes were:

1: CHANGING PLACES

"This shift in wealth from energy producer to energy consumer, to the extent it is not short-term, will play out as the Dan Aykroyd/Eddie Murphy comedy, "Trading Places" where a diabolical plot forced a wealthy man to trade places with a street beggar. In the movie, the world of each man was turned upside down, and, at first, each one found it difficult to function normally. However, over time, both men managed to benefit from the change.

We are in the early economic stages of such a shift from the oil producer to the oil consumer. This move will favor the consumer even though producers will suffer. The net economic effect will be positive as the consumer accounts for ~68% of the economy while the energy sector and related capital expenditures account for less than 10%."

This shift came too quickly and was larger than anticipated introducing dislocations between the energy sector and the balance of the economy. The S&P Energy Sector fell by 21.1% in value while the S&P Consumer Discretionary Sector rose 10.1% a difference of 30%! In comparison, the S&P 500 that is a broader measure of domestic stocks rose only 1.4%. As this year began, consumer confidence was above the long-term historical average as reflected in the chart below demonstrating the positive shift to consumers from producers.



"No one ever lost money betting on the American consumer" is a quote we used to hear more of than we do now, but the concept still applies. Consumer spending continues to grow as does employment. The difference this time around is that people are limiting their spending to slightly less than their incomes. Much of the angst over slow economic growth has been based on this simple fact—which actually is a good thing since many consumers have reduced debt burdens.

What could this fact mean for 2016? We can reasonably project continued spending growth at rates similar to those of 2015. We could make a good case for faster growth (higher wage growth, more jobs) and for slower growth (job slowdown, continued wage stagnation). A consumer-led recession is unlikely as substantiated by the following:

a) Consumer confidence remains at healthy levels despite all of the recent uncertainty regarding terrorism, expectations for rising interest rates and the impact of the energy renaissance on the domestic energy producer.

b) Consumers are actually demonstrating long-term confidence by buying homes and cars—they are confident to assume that kind of debt.

c) Consumers have been responsible so there are few internal issues that will pull them back. It makes sense to assume that consumers will do at least as well this year as they did last year.

d) Lower energy prices will complement the impact of a stronger dollar resulting in continued low to no inflation. Import prices should continue to fall and the combination of rising employment and more disposable income should bolster economic growth.

2: KING DOLLAR

"Global economic turbulence has been accelerated by the surprising strength of the dollar. As the U.S. economy has been growing faster than both Europe and Asia, the dollar is strengthening against the Euro and the Yen and is currently trading at an 11-year high. A stronger dollar benefits importers, and thus consumers, while it penalizes companies that export and accept payment in foreign currencies or translate their foreign earnings into dollars."

The rapid fall in the price of oil contributed to a continuing surge in the value of the dollar. Foreign economies should benefit from this trend as U.S. exports are more expensive than domestically produced goods and services. Over the past two years there has been a surge in visitors to Japan as that country's currency, the Yen, has fallen dramatically against the dollar. Essentially an unfettered dollar will slow U.S. economic growth and accelerate the growth rates in other industrialized nations. One caveat is that third world countries that peg their currency to the dollar could encounter financial problems. U.S. consumers who travel will benefit as the value of the dollar rises when spent abroad. Multinational companies that depend on exports will suffer from both a reduction in revenues and the translation of sales back into dollars. The U.S. dollar index is near record highs at this writing.

3: RISING INTEREST RATES

"Stock market observers are concerned about a shift in monetary policy toward higher short-term interest rates. Such a move may not be a thorn in the side of the current secular bull market because rising interest rates shift wealth from borrower to saver. Since there are millions of savers, especially individuals in retirement who want "riskless" investments, rising interest rates on CDs or money market funds will fuel increased spending and improve standards of living—thus creating more prosperity."

For the past few years, economists have quarreled over the monetary policies of the Federal Reserve. Since the financial crisis in 2008, the Fed has kept interest rates at or near zero supposedly to help the economy by encouraging business borrowing for investment. The Federal Reserve waited until December to raise interest rates and then by only a token range of 25 to 50 basis points. As a result, retirees and those saving for retirement did not benefit from higher interest rates on their savings. Essentially interest rates remained unchanged for 2015. Corporate borrowers continued to benefit from low rates and refinanced debt at lower costs. World turmoil and falling commodities' prices are likely to keep the Fed on the sidelines in 2016 even though the consumer side of the economy continues to do well.

Unfortunately, a higher interest rate policy may push the dollar higher on international currency markets and, in turn, slow exports and detract from economic growth. In other words, a policy to slow the U.S. economy may prove to be the catalyst to a surprising economic decline.

OUTLOOK & CONCLUSIONS

So, where do we go from here? As portfolio managers who specialize in the management of fixed income and equity investments either directly or through exchange-traded funds, we take a pragmatic approach to managing both our personal portfolios and the portfolios of our clients. In late 2000, we raised 100% cash saving clients from the full effect of the bear market of 2000-2002. Again, in 2008 we raised 100% cash in our growth equity accounts by October and avoided about half of the second major investment calamity of the first decade of the 21st century.

Today, we do not see the conditions for producing any serious or prolonged decline in the broad stock market in 2016. The wealth shift from energy producer to energy consumer is a secular trend that will ultimately benefit the global economy as global consumers experience a rising standard of living. In the meantime, we will need some patience as the financial pain inflicted on energy producers will cause some dislocations in the short-term. A similar transition occurred in the early stages of the 1970s shift in wealth from energy consumer to energy producer triggering the recession of 1973-1974. This time around the shift will favor the consumer.

Many investors are pessimistic about China's economy, partly because they don't understand the shift that is taking place as the economy develops from heavily manufacturing oriented to a blend of manufacturing and domestic-led consumption. This shift has begun and China is no longer an export-led economy as domestic consumption and services are bigger than manufacturing -- the Chinese consumer now accounts for 58% of GDP growth on the back of unprecedented income growth. For the first three quarters of last year, real per capita disposable

income rose more than 7%, while over the past decade, real urban income rose 137% and real rural income rose 139% according to Matthews Asia. Some of that increase was driven by government policy: the minimum wage in Shanghai, for example, rose 187% over the past 10 years. (In the U.S., real per capita disposable personal income rose by about 8% over the last 10 years.)

This strong consumer story can mitigate the impact of a manufacturing slowdown but cannot drive growth back to an 8% rate. While we will continue to see a deceleration to a “slow” growth rate of 6.9%, that rate is on a base that is 300% higher than it was a decade ago meaning that incremental expansion in China is about 60% greater than it was ten years ago. China will continue to become an ever larger component of global economic growth.

And it is worth noting that one reason the fall in the A-share market didn’t depress Chinese consumers is that although the market is down sharply from its recent peak, the story isn’t quite as bad as some make it out to be. More recently, we witnessed these growing pains on Chinese stock exchanges with newly implemented rules in 2015 disrupting the “normal” trading of stocks. These types of mistakes will be learned from and should not directly affect U.S. exchanges.

On our domestic shore, we will likely have overall economic growth of 2-2 ½% with inflation in the 2% range as measured by the consumer price index. Interest rates are also likely to stay low by historical standards. One unknown is who will be the winner of the election and the impact a new president will have on economic policies that ultimately affect financial markets. We have learned not to comment on political outcomes but 2016 is shaping up as an exciting year for a national election. Usually voters know well ahead of time who the party leaders will choose to be their candidate. As 2016 begins there is an unusual amount of uncertainty attached to who will be the final combatants for the presidency. The distinction among the candidates can influence financial markets if a candidate becomes an apparent nominee. Economic policies can effect markets and such policies are likely to be developed and modified as the election draws closer. For example, Ronald Reagan was trailing in the polls when he ran against Jimmy Carter until he announced an unexpected major tax reform program. Outsiders may also play an important role in affecting the final platform of each of the candidates.

As we reflect on what can go wrong with our outlook, we reiterate the importance of stability in both oil prices and the value of the dollar as keys to keeping the economy and financial markets on an even keel during this transition period.

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