Market Commentary - March 2016

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Market turmoil has eased significantly since mid-February. At least for now, February 11 seems to have been another successful retest of the August 2015 lows for both the S&P 500 and Dow. Since the February low, the S&P 500 has risen about 9% (through March 2).

Does this mean the correction is finally over? We are not convinced that it is. As long as stock prices continue to move in tandem with the price of oil, we remain concerned that this rally could prove unable to support itself. In order to become more constructive, we would want to see a de-coupling of oil prices and stocks with a resumption of market upside driven by fundamentals. Corporate earnings, GDP growth, and employment trends should matter more than oil prices. When the stock/oil linkage is broken, we will feel more confident that a rally can be sustainable.

Reflationary vs. Deflationary Pressures

The bulls and bears continue to slug it out although it is clear the bears have had the upper hand since the stock market peaked last April. Our late January Market Commentary, "China, Oil, and the Fed," summarized the three factors affecting stocks to the greatest degree on a daily basis. However, the macroeconomic argument between the bulls and bears is about **reflation** versus **deflation** and the ramifications of each possible outcome. Here is a recap of each position:

First, the bulls believe …

- **Reflation** is the likely outcome of our current economic malaise. The economy will accelerate from an already acceptable 2%+ annual growth rate. Eighty percent of the U.S. economy (the service sector) continues to grow. Only the manufacturing sector is in decline, mostly due to slow export markets.
- Commodity prices, including oil, will bottom this year and then begin to head higher. The current supply overhang should be eliminated later this year due to restrained supply growth. This will be enough to put a bottom in place for oil and bear in mind that demand remains on the rise.
- Inflation will eventually rise based on cyclical factors including recent job gains and wage increases. The Fed will continue to raise interest rates in small increments to offset this.
- Corporate earnings growth will accelerate to more normal levels once GDP growth accelerates.

In summary, the bulls think we are experiencing a cyclical stumble and nothing more. As the economy and earnings accelerate, the stock market will resume its multi-year advance.

The other side of the argument has been winning the day for most of 2016, however. That is, deflationary pressures are constraining worldwide economies and markets and will hold our market captive for some time.

The bears cite these deflationary pressures …

- Global economic growth is forecast at only 3% for 2016 which may signal impending recessions in some developed economies, including the U.S. (worldwide economic growth was 5% in 2007, the year before the Great Recession). The U.S. may not be able to avoid a recession.
- Along with slower economic growth will come stagnant corporate earnings growth. Why? Lack of corporate pricing power. International markets are fiercely competitive and the strong U.S. dollar reduces our companies' ability to raise prices. While this is good for consumers, it's bad for corporate earnings and stock prices.
- Negative interest rates confirm that deflationary pressures have already taken hold in many countries and reflect desperation on the part of central bankers struggling to kick start their corresponding economies. Bears think it is too early to tell if negative interest rates will ignite growth–but in the end they will have little positive long-term impact.

So where do we stand on this debate? Which side will eventually win the argument?

We would agree that our markets are suffering a **cyclical** downturn, but to call it a **secular** shift is premature. Our economic system creates cycles in the economy, commodities, interest rates, stock prices, etc. This is nothing new and cycles in a capitalist system are the norm. Our economy is mostly healthy and growing. If it stumbles, the Fed will try to save the day by reversing any rate increases and may even resort to another round of quantitative easing. Corporate sales and profit growth will be aided by a weaker dollar (which we expect later this year).

We can't deny, however, that deflationary pressures exist. Worldwide economic growth is slowing, commodity prices remain depressed, the effect of negative interest rates overseas is still uncertain, and a strong dollar is deflationary. Although stock valuations are lower since last April and many stocks are still in bear market territory, as long as deflationary pressures remain, stocks will have a hard time mounting a sustainable advance. **Our expectation is that stock prices will continue to struggle until U.S. GDP and earnings growth accelerates, the U.S. dollar weakens, and the oil price-stock linkage is broken.**

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