

CLEARVIEW

WEALTH SOLUTIONS

Given the recent volatility of the markets, we decided to share some of the questions on the minds of our clients and our thoughts in response.



Is China Really That Important to U.S. Markets?

The U.S. economy's exposure to China's is relatively small... but not insignificant. Last year around two percent of S&P 500 company sales were to China while 8% of American exports were shipped there (which accounts for 0.7% of GDP). There will also be loss to the U.S. from other countries as a result of China's slowdown. Brazil, Indonesia, Canada and Australia, among others, export massive amounts of raw materials to China. As they export less, they will be able to

buy fewer products from the U.S. The ripple effect is likely to touch all developed countries, not just the U.S. China recently announced 7% annualized growth but their reports are not seen as credible. **However, even at 5% growth China accounts for 50% of global growth.**

We continue to closely monitor China's economy. To be fair, China's current economy is a mixed bag but not a crisis. The headlines report that exports are crumbling, bad loans are rising, and the industrial sector is at its worst since the global financial crisis. Nevertheless, their consumer economy is quite strong. The service sector (bigger than industrials) is growing rapidly, retail sales remain robust, and housing prices remain solid.

If China's growth is decelerating but still strong compared to the rest of the developed world, why the intense reaction in global equity markets? Partly because many U.S. economists think the true growth rate of China's economy is only 2-3%, which would be considered stall speed for the second largest economy in the world. In addition, their recent devaluation of the yuan is seen by some as a desperate attempt to avoid a hard landing. Finally, their stock market has plunged 40% since mid-June, although that came after a massive rally in share prices. Investors may fear the U.S. could experience a similar decline.

Both China's economy and its stock market fortunes will continue to play a role in determining the direction of our markets. We expect that role to diminish later this month as U.S. investors focus on the September 16-17 Fed meeting and Q3 corporate earnings announcements (beginning in early October).

Does the recent stock market correction signal that the bull market is over?

The S&P 500 has compounded at over 20% for the last three calendar years. It should not be surprising that the market needs a breather. It doesn't mean, however, that returns will be negative for the year or that the bull market is over. Corrections typically occur quite frequently—usually every 12-18 months. Since 1950, the S&P 500 has spent about 1/3 of its time in correction territory. There is nothing extraordinary about being in a correction. **After a sharp downturn in the market (like we just experienced), the lows are often retested. We expect that may happen in the coming weeks.**

The average length of a bull market is four years, although some last much longer. The current one is now 6 ½ years old. Age alone won't end this bull market, nor will current valuations. Usually an exogenous event surfaces to trigger a more serious downturn. Often that spark is the fear of a coming U.S. recession which we do not currently see on the horizon. So what will trigger the next bear market? Additional deceleration in China's economy? A soaring U.S. dollar and its effects on earnings? Further collapse in commodity prices, including oil? We place a low probability on any of these factors causing a bear market in the near term.

Stocks still have plenty of catalysts to push prices higher including: low interest rates, reasonable valuations, solid earnings growth (10.6% expected in 2016 according to Factset), and shareholder-friendly managements that encourage healthy dividend increases and share buy backs. **We may be in the later innings of the bull market, but it could last a while longer in spite of warnings from market bears. After all, Alan Greenspan's famous "irrational exuberance" warning in 1996 was followed by a doubling of stocks prices over the next three years.**

The Fed is expected to begin to raise rates (the Fed Funds rate) possibly as early as this month. Will this sink stocks?

Not likely. This is the most telegraphed rate hike in Fed history although the timing is still uncertain. The market should have had plenty of time to digest this first increase of 25 basis points. What really matters is future rate hikes; how many more and how soon.

The Fed's mandate is to help manage the real economy (unemployment and inflation levels), not the markets. However, the Fed has been market sensitive since the 2008 financial crisis. One could argue that Fed policy has largely determined market levels. This would explain why investors are so concerned about a change in policy and a ¼ point

increase in the Fed funds rate.

Looking back at history, going back to 1958, stocks rose in 12 out of 14 tightening cycles. Returns, of course, are better when the Fed is more accommodating. Yet it is likely, based on history, investors will make money in the next tightening cycle.

If we are late in the stock market cycle as you suggest, why not go to cash and wait for the next upward cycle to begin?

Market timing is an attractive notion but doesn't work in the real world because no one can see the future. It actually can be dangerous because it often detracts from long term wealth accumulation. Here's how: the market is unpredictable and often rises in quick bursts. Returns can be lumpy. Long term investors can't afford to miss the big up days because it just kills long term performance. If you missed just the 10 best days in a 20- year period (1994-2013) your annualized return would have been cut by 40% (from 9.22% fully invested to just 5.49%). If you missed the 20best days, your returns were cut by 67% (down to an annualized 3.02%). (Source: Yahoo! Finance). **Time invested in the market is more important than trying to time the market.**

What is your current portfolio strategy? Are you still finding attractive stocks to buy?

With the recent correction, share prices in many great companies have become attractive again so we are currently finding many potential purchases. If that changes (because the market rallies sharply) we would rather leave sales proceeds in cash than reinvest in overpriced securities.

We have become more defensive over the past few years in preparation of the end of the cycle and have been adding investments in the healthcare and consumer staples sectors (two traditionally defensive areas). Our Core Equity Strategy now has about 40% invested in those two sectors. We have increased financial holdings as higher interest rates should benefit stocks in that sector, especially banks. Our small weighting in energy stocks has been reduced even further. We think oil prices will stay low for longer than most people expect. In our view, the worldwide supply/demand imbalance for oil will continue into late 2016 or early 2017. Commodity sensitive stocks (ex-oil) are not owned in portfolios due to the ongoing worldwide deflationary price pressures. The tech sector is currently market weighted. Finally, industrial stocks have been reduced based on modest economic growth forecasts and their exposure to weak overseas markets.

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