CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 8, 2016

Turning the Page

Major stock and bond markets were essentially flat in 2015, while currencies, emerging markets and commodities fell sharply. Weak global demand will continue this year.

China is finding it difficult to change its economy to one less dependent upon export of manufactured goods. Its efforts to loosen control over its stock market and its currency are counterproductive. Its policy blunders spook markets around the world.

However, with its vast resources, China can survive its mistaken policies.

By

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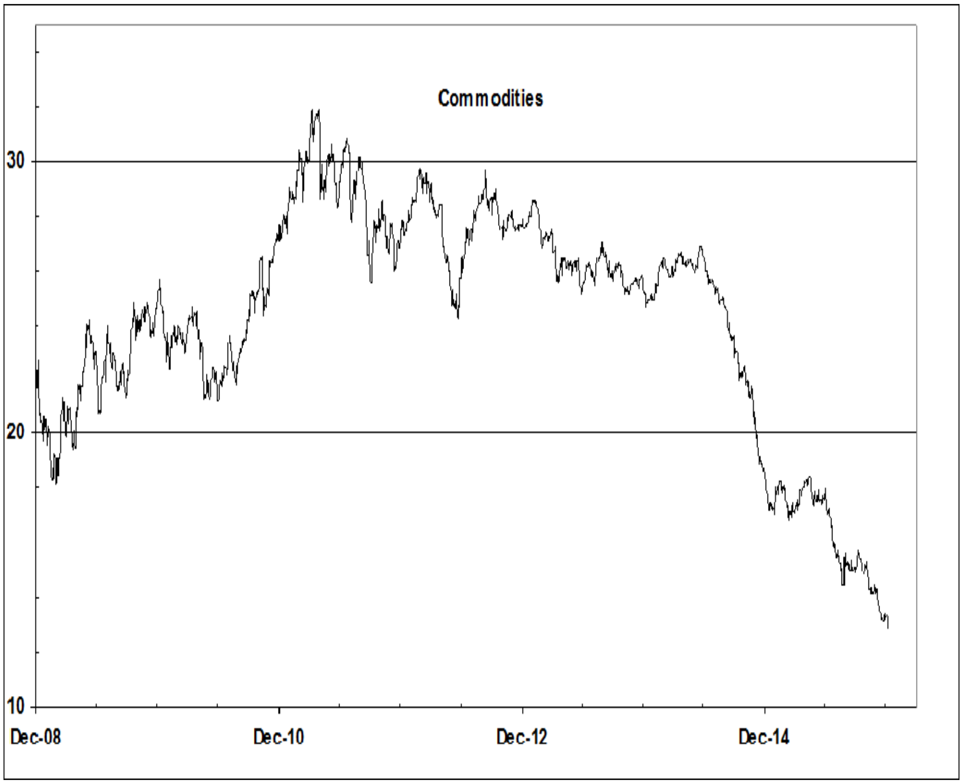
As the calendar turns to 2016 comes the occasion to look backward to last year and forward to this new one. First, the look backward: The principal US markets ended up the year essentially where they began. In unusual fashion, the S&P 500, the principal US stock benchmark, gained a mere 1.2% including dividends, while the Barclays Aggregate bond index of all tradable US bonds gained 0.5% including interest. (It was only dividend and interest payments that made returns barely positive; the indices were both in the red before dividends and interest.) Money market funds yielded essentially zero. For global investors like ourselves, there was not much else on offer. Using the MSCI All-Country World Equity Index (a well-respected and widely followed index), a portfolio balanced with 60% stocks and 40% bonds would have returned nothing, even if one had hedged European and Japanese currency exposure, as Core does. (Because of the strength of the US dollar, returns of non-US stock markets, when expressed in dollar terms, were decidedly negative.) To state the obvious, it was a rather difficult year to make money.

However, it was an easy year in which to lose money. Some notable markets, which were very strong in the last decade, had sizable losses in 2015. Crude oil has fallen from its June 2014 level of $115 per barrel to $33 as of this writing! Oil was not the only commodity to fall in price: Industrial commodities lost about 21% in 2015; agricultural commodities about 16%, and gold about 10%. In fact, 2015 was the fifth straight year in which commodities as a group declined in price. Stock markets in developing countries--the ‘emerging markets,’ as we call them--lost about 16%. Virtually all foreign currencies fell in relation to the dollar’s value, as they have for a couple of years. Although these statistics look backward, they have some bearing on what is to come.

The underlying forces behind the markets last year and this remain the actions of the major central banks and weak global demand. The US economy shows persistent strength, at least when compared to Japan’s and those in Europe. As a result, the Federal Reserve has begun (after some hesitation) the process of raising interest rates and tightening monetary policy. Meanwhile, against the backdrop of those weaker economies, the Bank of Japan and the European Central Bank both are deeply engaged in ultra loose monetary policy actions. Big producers of oil and industrial commodities, including Canada and Australia among developed economies, as well as emerging economies like Russia, Brazil and Indonesia, have experienced very sharp declines in their currencies against the dollar. Russia and Brazil, with separate other problems (sanctions in Russia’s case and terrible mismanagement in Brazil) suffer sharp and prolonged recessions and steep stock market declines.

The chart below shows the large decline in overall commodities prices in the last five years, a decline that has accelerated in the last two.
This decline will end and will then offer investors fine returns. Emerging markets and foreign currencies share these characteristics.

China is a force in the world's economy and financial markets that cannot be ignored, even if one holds steadfast to the view that investing directly in China is to be avoided. It has become the second largest economy in the world and, for a decade or more, was the engine of global growth. Now its economy is slowing, as it attempts to change from an export-driven economy to a more domestically oriented one. Meanwhile, having piled up a huge store of treasure (some $3.3 trillion in foreign currency reserves), it seeks to be a full participant in world markets and to challenge the role of the US and the US dollar in those arenas.



As we discussed in Core's September 2015 letter, China's handling of it currency and its stock markets is amateurish and ham handed. It is unwilling to permit the markets to determine price levels of its currency and its stock market. It announces policies to restrain market declines, but is forced to withdraw those policies within days because its actions worsen declines and heighten price swings. The actions are deeply unsettling to global markets, as demonstrated again in this first week of the new year. Twice this week, China closed its stock markets after sharp declines. Its experiment with 'circuit breakers' ended in four days. This week has also presented a widening between the value of its currency in its domestic and controlled markets and those off-shore and uncontrolled markets. As in August, this demonstration of China's ineptitude has unsettled financial markets far away from the Middle Kingdom.

For 2016, and putting aside the immediate China problems, we can expect more of the same: relatively weak global growth, falling commodity prices, strength in the US dollar and modest growth in the US, Europe and Japan. As a result, Core is maintaining your investments in the US, Europe and Japan, while avoiding currencies and emerging markets and maintaining somewhat high levels of cash. However, before too long, these trends of falling commodities and the rising dollar will come to an end. We will then have the opportunity to invest once again in foreign currencies, in commodities, and in emerging markets—at prices far below those that prevailed when we sold our positions last. You will remember that, in the years preceding the 2008 - 2009 recession and financial crisis, oil, the oil stocks, foreign currencies and emerging markets, especially those with connections to China, were strong as new rope. Although China is very unlikely again to see the rate of growth it experienced during those years, the adjustments to its slowing growth and changing economic structure will have occurred. Currencies, commodities and emerging markets will again find their time in the sun. We Core investors will participate.

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