Monthly Commentary

January 2016

Warped expectations

We live in a world of warped expectations where Americans are excited about the lottery, comfortable in cash and scared of stocks.

As this is being written, the Powerball jackpot has climbed to $1.3 billion, and, while the odds of winning are the equivalent of being struck by a meteor, tens of millions of Americans will optimistically put down good money to play. In 2014, Americans bet over $70 billion in state lotteries. These lotteries pay out just two-thirds of their ticket sales in prizes. This makes the "expected return" on lottery ticket sales approximately -33% with extreme volatility; almost everyone loses their stake and only a handful end up being multi-millionaires.

Americans are also very comfortable with cash. Last year M2 cash balances in the U.S. increased by 5.9% or $691 billion. This is almost twice the growth in nominal GDP despite the fact that cash accounts are paying virtually nothing. Indeed, using year-over-year core CPI as an inflation measure and the federal funds rate as a cash yield, the real return on cash today is in the region of -1.6% per year, far below the positive 1.8% real yield on cash balances seen in the 50 years before the onset of the financial crisis.

However, Americans remain very nervous about stocks. Last year, they withdrew approximately $160 billion from U.S. equity mutual funds, despite the fact that U.S. stocks have provided an annual average total return of over 11% since 1950 (as shown on page 62 of the *Guide to the Markets*).

The foundation assumption of economics is that individuals are rational. It is hard to see how such an assumption could survive a deep inquiry into Americans' behavior with regard to lotteries, cash and stocks.

However, on the narrower question of why U.S. stocks have had such a rough start to the year, there is a relatively simple answer: Investors are confused.

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Clearly, they are confused about China. Chinese stocks had a brutal first week of the year, with the Shanghai composite falling by 10% in total. Some have explained this as being due, in part, to weak economic data. However, the Chinese numbers were not that much worse than expected with the Caixin manufacturing and services indices falling a little but the official manufacturing and services PMIs rising. China **is** growing more slowly, but that is hardly breaking news and shouldn't have caused a sharp market reaction.

The problem was actually simpler. The government introduced relatively tight circuit breakers into the stock market, starting on January 4, whereby the market would shutdown altogether if the CSI300 index fell by 7%. The problem is that, in a highly volatile and speculative market, investors have an incentive to sell before the shutdown if they think it is likely. Then the People's Bank of China (PBoC) allowed the Yuan to fall also on January 4th, prompting speculation of further devaluation. The PBoC's move pushed the market lower and panicky investors did the rest.

The truth is that Chinese markets do not appear to be mature enough to weather a change in exchange rate policy without severe volatility. However, it is also the case that the Chinese government ultimately has more control over the economy, the flow of information and the behavior of capital markets than almost any other government. If the government wishes the PBoC to support the Yuan and for equity markets to stabilize, chances are that they will get what they want, even at the cost of slowing or reversing a march to freer markets.

Importantly, the Chinese problem is not a significant challenge to the U.S. economy, although the U.S. economy itself is a source of confusion to investors.

Clearly U.S. manufacturing is clearly still in some trouble, as suggested by declines in both the Markit and ISM manufacturing indices. However, this is mostly an inventory problem at this stage. Final demand looks very good, as illustrated by strong vehicle sales and solid retail sales (outside of price-related declines in gasoline sales).

Employment is also growing strongly, with 292,000 non-farm payroll jobs added in December. The reality is that, while a continued inventory correction could reduce 4th quarter GDP to close to 1% growth, real GDP still looks likely to increase by between 2% and 2.5% over the course of 2016.

We are also now at the start of the earnings season. Profits are still being impacted by lower oil prices and a higher dollar. However, the year-over-year comparisons on these issues are easier than in the third quarter and should result in a return to positive year-over-year growth in operating earnings.

Overall, the U.S. economy isn't booming, profits aren't soaring and China isn't out of the woods. However, given still extraordinarily low cash yields and slow but steady growth in the global economy, the start-of-the-year selloff reflected fear more than fundamentals. In the long run, fundamentals should prevail – the trick for investors is to recognize this early enough and get invested appropriately before these fundamentals are once again priced in.

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