KayneCast

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Episode 25

CIO Commentary on Recent Market Volatility

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It's been a very difficult year to say the least in equities so far. The first half of the year was characterized by a very tight trading range in the S&P 500 and stocks in general. Stocks were trying to make some progress, but there were numerous headwinds in the first half of the year, which we've talked about earlier.

In the first quarter there was bad weather in the Northeast again—very similar to the year before—and a port strike in Long Beach, which prevented a lot of retail trade from being done in the first quarter. Greece made headlines in the second quarter with the bailout package, and the market was in a tug-o-war with that, with whether or not Greece was going to stay in or get out of the Euro, and whether or not they were going to get their bailout package done, which since, they obviously have.

Additionally, China was slowing throughout the first half of the year. Emerging markets were struggling most of the year, not even in a trading range, but actually declining and not doing well. Energy stocks, in particular, continued to struggle based on commodity prices, particularly oil having plummeted from $100 plus to the low $40s over the last year. And what we saw was a lot of weak stocks that were having the near-term fundamental issues. The companies' stock prices had continued to decline, and the market was increasingly focused on a few companies that were doing impeccably well, principally in areas like retail and the internet sector—and technology in general—which were continuing to grow in even what most would consider a fairly lackluster environment. We've been calling for about 2, 2.5% GDP growth this year coming into it, and we think we're on track to get that, but it's slow-to-moderate growth at best in the U.S., even before all these problems started to transpire overseas.

So what's happened here recently, and particularly this week, is that markets have become increasingly concerned about the outlook for global growth, and the problems that have been occurring—particularly in China and emerging markets—have gotten to a boiling point where U.S. investors have started to notice and have started to question the ability of many U.S companies to grow in this fairly adverse global environment that we're in.

China's devaluation didn't help these matters. It really brought to the forefront that maybe China knows something about their poor economic growth that investors didn't already know. Keep in mind, as I mentioned earlier, Chinese growth has been slowing for about four years, really since 2010. And as that economy makes a transition from an investment-led economy—which was characterized by building office buildings and bridges to nowhere, etc.—that investment phase is well behind China, which is why commodities have struggled so much over the last several years. And the economy is increasingly dependent upon the consumer in China for growth, and the consumer is still a small portion of Chinese-reported GDP, only about 35% to 40%.

So that economy is undergoing a transition. It will continue to undergo a transition as it moves from an investment-led to a consumer-led economy over time, and it will take time. Many observers have started to increasingly worry that China is headed for a hard landing or some sort of crash, and clearly that's a risk. It's been a risk for several years. It so far has been manageable, but I would point out that Chinese authorities do have a fair amount of flexibility. They've got several trillion dollars in currency reserves to stabilize their currency if desired. They also have interest rates at around 4, 4.5%, which they could lower over time. They're not at zero like other parts of the developed world are in terms of short-term interest rates.

So I think what's happened this week is it feels like a short, brief, painful correction of the garden variety, which we haven't had in quite a while. Quite frankly, we were overdue for one. It's been 47 months since the last correction, which is the third-longest running period in stock market history without a pullback of 10% or more. It seems like we're highly likely to get one. We're close already, and we may have a little more to go, but I think if you look at emerging markets, they've already obviously entered correction territory, if not bear-market territory in some cases. Europe, whether it's Great Britain or Germany, has already corrected 10% or more on their major indices. And [in] the U.S. of course, the Russell 2000—as we speak today—touched correction territory, down 10% off its peak briefly. NASDAQ is also very close to a 10% correction, and the S&P is down around 6, 7% as we speak.

So, you know, these markets [are] very similar to what happened the first couple of weeks of last October, if you recall. It sort of feels like that again, where it's a major growth scare, and investors are pulling in their horns, and risk aversion is growing, and people are taking some chips off the table.

The other thing that occurred this week is that they started killing the companies that were even the impeccable growers, which heretofore had held up very well. The weak stocks with weak fundamentals, like I said, were getting hit and continuing to go down, but even companies with sort of impeccable fundamentals this week started to get hit as people started to take profits really across the board. So it's one of these risk off-trades where there's little dispersion and little differentiation between companies. People just want out for the time being, and hopefully this is a garden-variety correction and not the start of something more that, you know, occurred like in 2008; a global recession or some sort of global meltdown across the board that becomes more significant in terms of earnings and earnings progress.

The weight of the evidence today would suggest this is just a correction. However, we'll continue to remain vigilant and make sure that this is not spreading and that we don't see any major impact on economic activity going forward. To reiterate once again though, we do not expect robust growth. We think the U.S. will continue to chug along at a moderate rate at best, in the 2, 2.5% range. And companies will be able to grow their earnings in that sort of environment assuming the rest of the world doesn't completely fall apart. Weakness in Europe, and China, and other overseas markets [is something] U.S. companies have been dealing with for quite a while. This isn't anything new, and their earnings have continued to show pretty good growth rates even in those types of environments, even in periods when the U.S growth—like in the first quarter of this year—wasn't doing well.

So, with that, I thank you for your trust and confidence. These are difficult times and difficult equity markets. Business is cyclical. It's not always great. Stocks don't always go in one direction, and sometimes these shakeouts along the way are necessary for the market to regain its composure and head higher over time.