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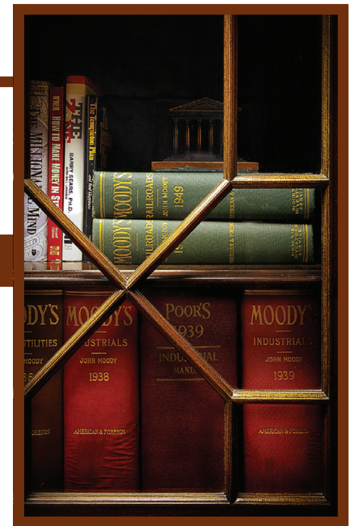

Over-reaction or Opportunity?

The start of 2016 was worse than almost anyone could have imagined – at least in terms of the performance of global equity markets. Huge 1-day losses on the Chinese exchange triggered circuit breakers and closed markets there – sometimes only minutes after opening. US markets fared much better, but were still down sharply on fears that the Chinese slowdown, among other factors, would have major global implications.

Slowdown fears put further downward pressure on already depressed oil prices causing the price of crude (and the price at the pump) to hit levels not seen in a decade. If these factors weren't enough, the markets were still digesting the Federal Reserve's first interest rate hike since before the Great Recession.

Piling on top of all this are the myriad unknowns and uncertainty of the upcoming presidential election. The long-held presumptive nominees, on both sides, are struggling to connect with voters; while unexpected front-runners give the establishment, and markets, reason to pause.

Between China, oil, the election, the Federal Reserve's interest rate policy and a possible global growth slow-down, there is no shortage of reasons for investors to be concerned. Before panicking however, it is wise to consider some of these factors to determine whether they are even worthy of our anxiety.

The Presidential Election

Many things move markets, among them are expectations - about a new product, future earnings, mergers, and yes, even political elections. Political elections can have lasting effects on the markets. Take for example if a sudden and significant tax increase were to be levied on companies. In such a scenario profitability of these companies would drop, as would their stock prices.

Let us also remember that in the United States no legislator can take unilateral action. There exists a checks and balance system in the form of Congress and the Supreme Court. The President, no matter what their party affiliation, is largely hamstrung by the Senate and House of Representatives. They cannot implement new policies without the approval (and more importantly the money) granted by Congress.

To further settle the Republican vs. Democrat debate, consider the last four elections. Barack Obama, a Democrat, won the most recent two elections. The S&P 500, in those years, returned 16.0% (2012) and -37% (2008). Republican, George W. Bush, won the two prior elections in years where the S&P 500 index returned 10.9% (2004) and -9.1% (2000).[1]

In short, no conclusions can be drawn for market performance from party affiliation. Presidents and parties will come in and out of favor but largely their impact on markets is a result of investor expectations not a direct result of the candidate or their campaign promises.

Oil Prices

Commodity prices have been weak for some time. Oil, being a commodity, and one that is currently in significant oversupply, has been leading the charge downward. Typically, one would expect weakness in certain sectors that may have exposure to commodity prices, in this case oil drillers, refiners and sellers. However, oil is unique in that lower costs help boost margins for almost all other industries, from airlines to delivery companies, to retail and online outlets that have to get goods from warehouses to stores and consumers. This dramatic decrease in the price at the pump puts more money in those businesses pockets.

Low oil and gas prices are generally positive for the economy. It allows companies to go about their daily business devoting less of their resources to transportation, which allows for greater profit margins, increased Research & Development (R&D) spending and other capital expenditures that grow the economy. In the past 4 instances where oil prices dropped 50% or more per barrel, the S&P 500 in each case rose over the following 12-month period. Those 1-year returns for the S&P 500 index were 26%, 16%, 21% and 33% – an average of 24%! [2]

The fear of oil causing a major tanking of the economy, similar to what housing did during the Great Recession, are overblown. Low oil prices are not a harbinger of doom for the industry, nor for the broader economy. In fact, one sector that has benefited handsomely from this is automakers, who had a record year in 2015, selling high-margin, low-mpg vehicles like trucks and SUV's.

Chinese Slowdown

When it comes to economic growth, the issue is not limited to China – it's an overall global growth story. With that in mind we must remember that our bull market has been fairly long by historical standards and a pullback, whether this year or the next, becomes more likely with every passing day. It is critical to never forget that growth is not linear. It comes and goes in fits and spurts with little predictability.

We must also consider what a slowdown in China means for US investors and consumers. China, while a major world economy, is but a small contributor to US Gross Domestic Product (GDP) and therefore even a severe slowdown in the Chinese economy has but a muted effect on the US.

Investor Sentiment

Ultimately, we need to ask ourselves one question – and it's imperative that we be honest when doing so – what is our true risk tolerance? If you are someone who is spooked into action by a market drop of 5, 10 or even 20%, perhaps you overestimated your willingness to accept risk – something that is easy to do particularly in a bull market.

While the market, in the short-term, is likely to continue to have a hard time finding solid footing on a day-to-day basis, we need to keep in mind that such market fluctuations – though perhaps more pronounced than many in recent memory – are not unprecedented. In fact such seemingly chaotic ups and downs are actually the norm and should be expected from time to time.

According to some estimates a 10% correction in the market happens as often as once a year, on average.[3] Equally importantly, these corrections are typically short lived. On average they last about 14 weeks, according to a study by MarketWatch.[4] The market is a reflection of sentiment and therefore is wildly unpredictable from minute to minute. In many cases the fluctuations of the market, particularly in the short-term, bare little resemblance to the more important and rational economic reality, which drives long-term results.

While we're not blind to the dangers, current conditions require an honest assessment of risk tolerance, a solid all-weather portfolio and a realistic assessment of threats. Combined these factors can go a long way to calming nerves and letting cooler heads prevail.

1 Source: First Trust; S&P 500 Index Returns in U.S. Presidential Election Years
2 Source: First Trust; Stock Market Returns After Significant Oil Price Declines
3 Source: Fool.com; 6 Things You Should Know About a Stock Market Correction
4 ibid. Research conducted by John Prestbo at MarketWatch. Data from the Dow Jones Industrial Index, 1945-2013.

Investment Counsel News

Inside the Office

If you like The Investment Letter we have great news for you – coming soon we'll be launching an online video version of our newsletter!

Outside the Office

The Flint water crisis is a tragedy. Investment Counsel has done a small part by donating and delivering much needed water to those affected.