Jurika | Mills & Keifer
Private Wealth Management

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Dear Investors and friends:

Given the ongoing turmoil in the stock market, we wanted to reach out to you to provide an update on our perspective.

Since the beginning of the year, the S&P 500 is down 8% and the MSCI All Country World stock index is down almost 9%. As most news commentators are quick to tell you, this is the worst start to a new year for the U.S. stock market since the beginning of recorded time. Talking heads dominate the airwaves with dire prognoses, stoking doubts and fears and working investors into a panic.

As we wrote in our ***Commentary*** two weeks ago, market corrections are a very normal occurrence, but like hurricanes they are never enjoyable when you are in the middle of one.

Although there are real reasons for concern about the global economy and financial markets, we continue to believe that things are not as bad as they seem on television, or as currently reflected in the stock and bond markets.

Historically markets almost always tend to overstate reality for better or worse and become obsessed with near-term events as harbingers of good or bad things to come down the road. Typically, the things with which investors are preoccupied in the present are not the things that ultimately matter over the longer term.

A few years ago, everyone was obsessed with Greece and the Eurozone falling apart. Then, those concerns faded away and markets rebounded until we hit the "Fiscal Cliff" and the threat of our Government shutting down. Then, there was the Ebola outbreak. And so on. These existential crises all came along and then went away.

Today, investors are worried about a smorgasbord of problems including oil, China, a global economic slowdown, divergent monetary policies, geopolitical risks, and a presidential election, to name a few.

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As we wrote in the Commentary, if you want to go looking for trouble, you are certain to find it, just as you can always find thorns when looking at a rosebush. Context and perspective are important. Focus on the thorns too closely, and you might just miss all the roses.

Let's look at a few of these:

Oil

In our view, plunging oil prices are not necessarily the spooky harbinger of a pending global recession, but rather, the normal result of overinvestment, overcapacity and overproduction in the energy sector. This, combined with slowing global economic growth, has led to a significant excess of supply of oil relative to demand. Eventually oil production will be reduced, supply will fall back in line with demand and prices will stabilize at a new sustainable level.

Low energy prices will continue to stress a number of countries and companies whose fortunes are dependent upon selling energy at higher prices.

But the majority of countries and companies consume, rather than produce oil. For the majority of the global economy, the economic benefit of falling oil prices is far greater than the cost to the energy sector. Cheap oil is much more of a rose than a thorn.

China

Much has been written and said about the slowdown in economic activity in China as well as many other problems including corruption, pollution, overcapacity, capital misallocation and waste, wildly speculative stock markets, high debt levels, suspicious economic data, skullduggery, and a bumbling and heavy handed approach to addressing these problems. The list goes on and on, but you get the idea. There are lots of things to worry about in China.

All of these things are true. There is massive overcapacity in the manufacturing sector and Chinese economic data surely overstates the actual growth rate. The Chinese economy is going through a major hangover and transition from a manufacturing and export-driven economy to a consumer-driven economy.

But the Chinese economy is very large and far more diverse than many people think. The consumer sector represents over half of the economy and still appears to be growing at a healthy rate. The Chinese government has been bumbling and heavy handed, but they are also smart, learn quickly, and have a lot of tools at their disposal to help manage through this transition. If the U.S. and European Governments were not willing to let their economy collapse, does it really make sense that the Chinese Government is? They will do whatever they can and whatever it takes to maintain economic growth and social stability.

Finally, the United States economy has relatively little exposure to China. Exports to China represent less than 1% of U.S. GDP and only about 2% of Eurozone GDP. A significant slowdown in China is not enough, on its own, to pull the U.S. economy or the Global Economy into a recession.

Economic Growth

A number of recent economic data points have shown a weakening trend. This is especially true in the manufacturing sector, which has been impacted by reduced capital spending by global customers for equipment related to construction, energy and mining. Growth has also been impacted by a strong dollar that has made U.S. goods more expensive and less competitive overseas.

But our economy is primarily driven by the consumer sector, which represents over 70% of Gross Domestic Product. The consumer sector remains considerably stronger than the industrial sector and is still showing signs of growth and vitality, despite slightly weaker recent numbers. Job growth is still good and the unemployment rate is close to 5%.

Monetary Policy

Investors are also worried about the Federal Reserve and its decision to raise interest rates by a whole 0.25% in December, with the stated intention to raise rates very slowly and carefully if economic data supported the move. If we really believe that our economy is so fragile that a small increase in interest rates is enough to send us into a recession then the stock market should not be trading near current levels. This makes no sense to us. We think the economy is far more durable and diverse than it is given credit for being.

Politics:

We will admit that politics are a wild card, especially this year, with non-mainstream candidates leading in the polls largely because of their extreme positions and entertainment value. If Donald Trump or Bernie Sanders were to actually get elected as their party's candidate for the presidential election, the stock market would likely have a reason for concern. This is not our base case assumption, but we never would have expected things to unfold as they have thus far.

Markets:

Part of what is freaking out the markets is the markets themselves.

We will be the first to admit that the stock and credit markets are not acting well and could easily fall lower before finding a bottom and starting to move higher.

The stock and bond markets have a history of spotting recessions before the data and economists support the same conclusion. This is especially true of the bond market.

The problem is that the financial market tends to spot many more recessions than actually occur. Not every downturn in the market foretells a coming recession. Most of the time, it's a false alarm and things pick up again.

As we said before, corrections are normal, but never fun. Since 1980, there has been a stock market correction every year, averaging around 14% a year. 27 of the 36 years, the market produced a positive return.

We think that market movements have been exacerbated over the last year by the increased participation of quantitative/algorithmic trading programs that spot trends and capitalize upon them. There are also likely some large sovereign wealth funds in oil-exporting countries that are selling stocks and bonds to raise money. The use of exchange-traded funds, especially by short-term investors has also led to increased volatility as large baskets of shares of stocks and bonds are dumped on often-illiquid markets.

Finally, there is an abundance of "short-termism;" a focus on the present moment, heightened by excessive and overly dramatic media coverage. This leads to a false sense of drama and a complete loss of perspective in what should be a very rational and long-term process.

Summing Up:

Putting it all together, we do not see sufficient evidence to convince us that the global economy is descending into a global recession. Despite the well-known problems, we also continue to see larger areas of growth and improvement in the U.S., Europe, Japan, India and even China.

Meanwhile, the stocks of very good companies have just gotten cheaper and, in our view, more attractive to hold as investments for the long-term. This is especially true compared to U.S. Government bonds.

We do not think of our view as Pollyanna, but rather realistic and measured. We have been in this business long enough to know that things tend to work out differently from the consensus view. In this case, the consensus view seems overly negative, which actually makes us feel more positive.

Our expectation is that markets are oversold and should recover from current levels. There may be some additional downside to come first, along with higher levels of volatility. But, unless we see meaningful additional deterioration in corporate earnings and economic data, we think the outlook for stocks and corporate bonds over the next year is good.

As much as we hate to admit it, we also know that we can be wrong as well. Our job is not to champion a single point of view, but rather to examine the facts, the range of probable outcomes, and to implement a strategy for our clients that makes sense given the risks and opportunities we see. Then, we make adjustments along the way as we get new and better information.

For this reason, we manage client portfolios focused on the long-term, and structure them to endure economic and market swoons and cycles. In particular, we balance diversified investments focused on areas of long-term growth and innovation, with more defensive equity, alternative and bond strategies to mitigate risk. This approach has served our clients well over the years and especially during the recent downturn, and we think that it is well suited for the world we see ahead, thorns, roses and all.

As always, we welcome your questions and comments.

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