Economic & Market Update, September 2015

Did We Just Enter a New Bear Market for Stocks?

By Richard Morey

The Stock Market

August was one of the strangest months for the markets we have ever seen. The U.S. stock market had its worst month in 5 years, dropping 6.6% for the Dow Jones Industrial Average and 6.2% for the broader S&P 500 index. Anyone listening to the financial news heard the cause may have originated in China, and they would probably be correct. Keep in mind that, until 18 months ago, for the previous 5 years 60% of all the world's economic growth was attributed to China. So a recession, or economic crisis, in China would almost certainly lead to a worldwide recession.

If you listen to the Chinese government, their economy has slowed down to its lowest growth rate in over 15 years, but they claim they are growing at 7%. This is, however, a complete farce, with even their own Premier admitting he completely ignores these numbers. If you look at the real driver of Chinese economic growth, the picture is grim indeed. China remains an economy dependent on exports. I remember around two years ago when they said their exports had grown 15% year-over-year. This sounds great, but it was actually the lowest growth rate in many, many years. Those days are long gone, as they reported exports **dropped over 8.5%** in July. Manufacturing numbers then came out on September 2, and they showed the all-important manufacturing sector isn't just growing more slowly but is actually shrinking. Another way to view their economy is through new car sales. In fact, the growth in car sales has been an almost perfect mirror of their overall level of economic growth. Last year car sales dropped substantially, growing at "only" 9.9% for the year. However, in June sales actually fell 3.4%. In July they **plunged 6.6%**! And these numbers just show the tip of what may be a very large iceberg hitting the Chinese economy at this time.

But the economic problems aren't just hitting China. Japan just entered another recession. And as of last week 23 emerging market stock markets have already dropped over 20%.

I could go on and on detailing the problems the world economy is now suffering. Perhaps most concerning is the fact there are trillions of dollars worth of loans that have been made throughout the world with money borrowed from the United States or (to a smaller extent) Europe and Japan. In fact, a whopping $9 trillion has been borrowed in U.S. dollars and invested throughout the emerging market countries. With the dollar rising dramatically against their currencies, this money is being liquidated so it can be repaid to the U.S. lenders before their currencies fall further versus the dollar. In 1997-1998 there was a financial crisis in Asia when their currencies fell versus the dollar and they had to start repaying their dollar-denominated loans. It was a true crisis for many of their countries, but the total amount they had borrowed in dollars was around $400 billion. Now they owe $9 trillion! In addition, back then the U.S. was somewhat insulated from a crisis in Asia, as our economy was the driver and they were the much smaller followers. But now, as mentioned above, Asia has been the engine for economic growth in the world – until now.

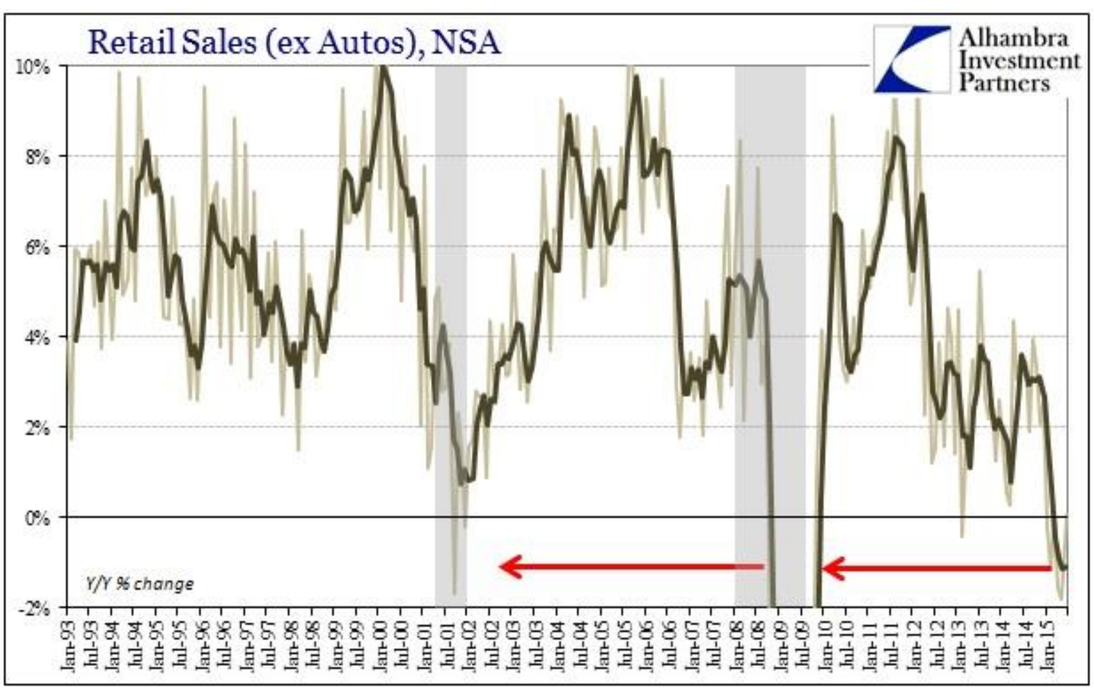
Making the situation worse is the fact the Fed is threatening to raise interest rates, which would drive the dollar even higher. While there remains a very good chance they actually won't be able to raise rates, even the possibility makes the world economy that much more precarious.

As a result of these and other factors, by mid-August the U.S. stock market had dropped into a "correction," meaning it had fallen over 10% from its highs. Then last week it roared back, gaining 5.6% from Tuesday through Friday. Does this mean stock investors can now relax? Definitely not. We expected stocks to come roaring back after the first shock. Quite simply, there was no way stock investors were going to give up their hope for more gains so quickly. The much larger concern involves the next few weeks and months. There is a very high probability mid-August was indeed the beginning of the next bear market for stocks. The stock market has lost money so far this year, and the Dow Jones Industrial Average has now lost 5.4% over the last 12 months.

Despite last week's rebound, it appears as if investors have gone from being optimistic to scared. Now keep in mind stocks had previously been rising not based on the economy or corporate earnings. The economy has remained weak while corporate earnings have dropped 16% since the 4th quarter of 2013. No, investors have continued to buy and hold stocks because of purely psychological factors. The largest factor is faith nothing can go wrong as long as the Fed has their back. This factor may still be somewhat in place, though August did see the first hits to blind faith in central banks. The hits came from overseas, as the Chinese financial authorities assured everyone they were going to make sure their stock market went back up – only to see it drop like a rock over the next month. In Japan their central bank assured everyone their (insane) money-printing would finally turn their economy around – only to enter their third recession in the last few years.

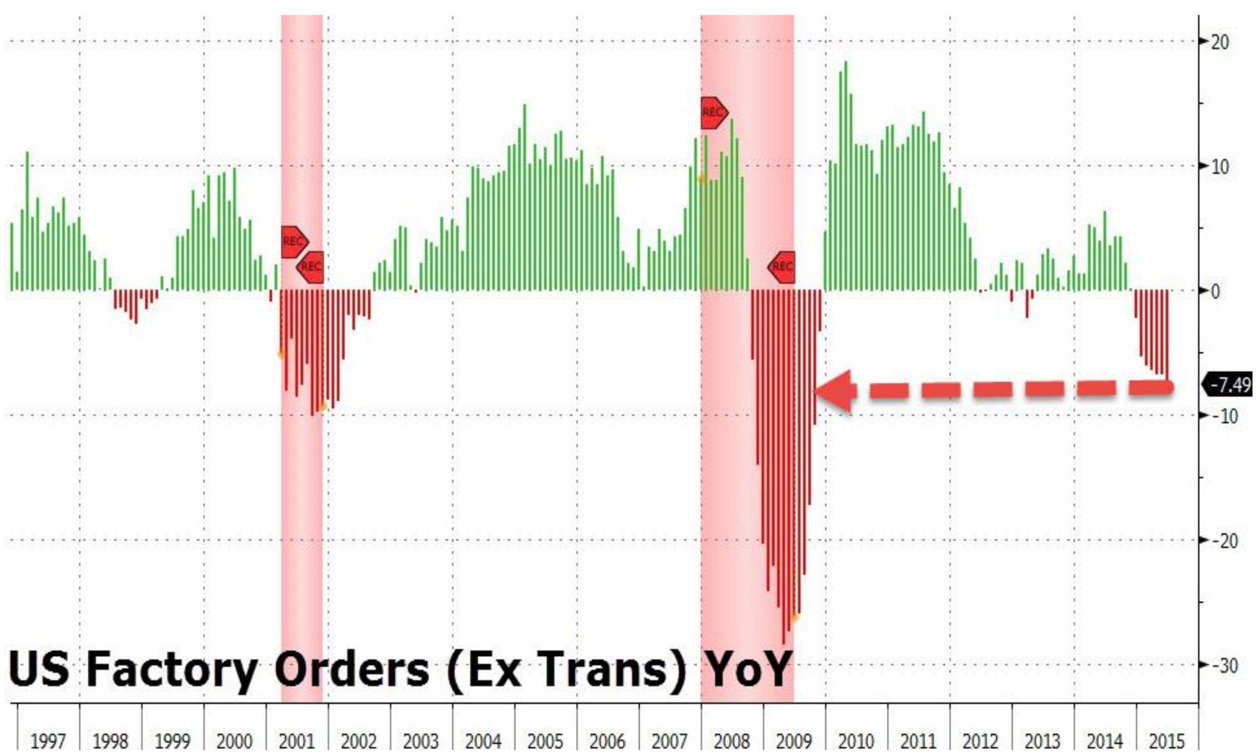
Another line of defense for the U.S. stock market comes from the financial services industry. Financial advisors en masse are assuring their clients they should have no concern about stocks. Instead, they said stocks always go up over time, and anyway a correction (10%+ loss) was good for the market longer-term. They of course did not entertain the thought we could soon see losses of 40-55%, which is the amount it would take to get stock prices back to average long-term valuations. And they definitely failed to mention that, on average, it takes over 15 years for stocks to get back to even after they fall from bubble levels. Instead, they point to 2008-2009, when stocks rebounded in a short 6 years. Unfortunately for most investors, this happens to be the fastest rebound after a severe bear market in history. Since this was the most recent stock market crash, I fear investors mistakenly now believe this is what always happens.

The other line of defense for stocks came from the financial media. They assured us the U.S. economy is not only sound but clearly rebounding. Since stocks only very rarely suffer large losses without a recession, and we obviously have no recessionary concerns, there is no need to worry about buying more stocks right now. Instead of analyzing this thesis in words, the following charts show large areas of the U.S. economy at this time, i.e. retail sales, wholesale sales, factory orders, industrial production, the percentage of working age people who have jobs, and income. Do these charts look like an economy getting ready to finally take off? (I was shocked when Bank of America put out a report today recently in which they had an analysis claiming there is now a 50% chance we will soon be entering a recession. When one of the regular "stock market cheerleaders" admits storm clouds may be on the horizon it's probably time for everyone to get out their umbrellas!) We'll begin with retail sales which account for 70% of the economy:

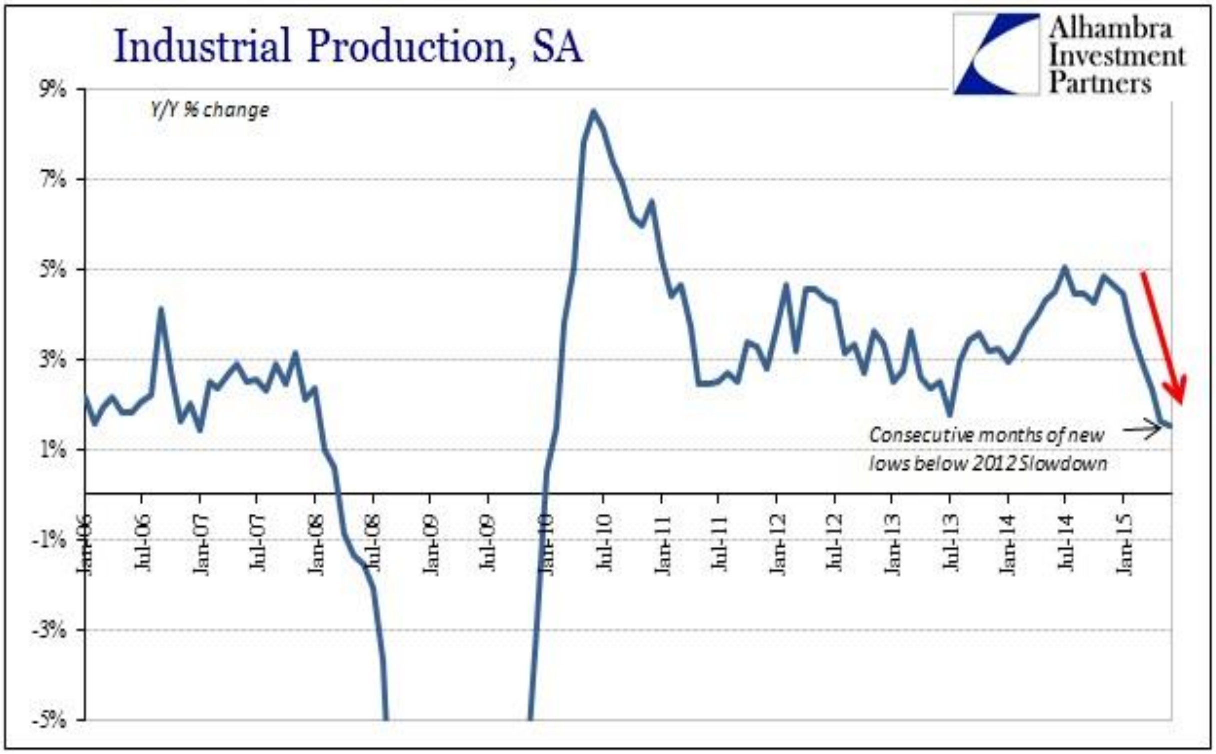


Similarly, wholesale sales have been plunging:

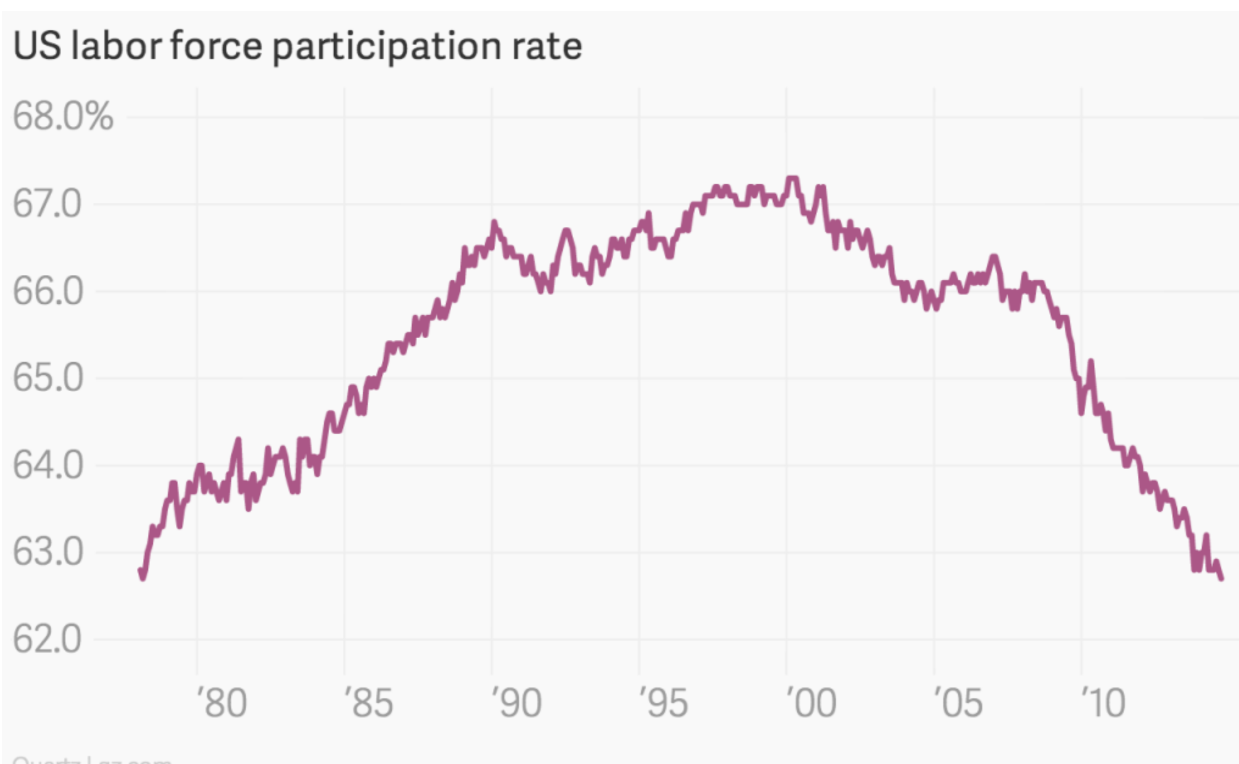
Factory orders have fallen to recessionary levels:



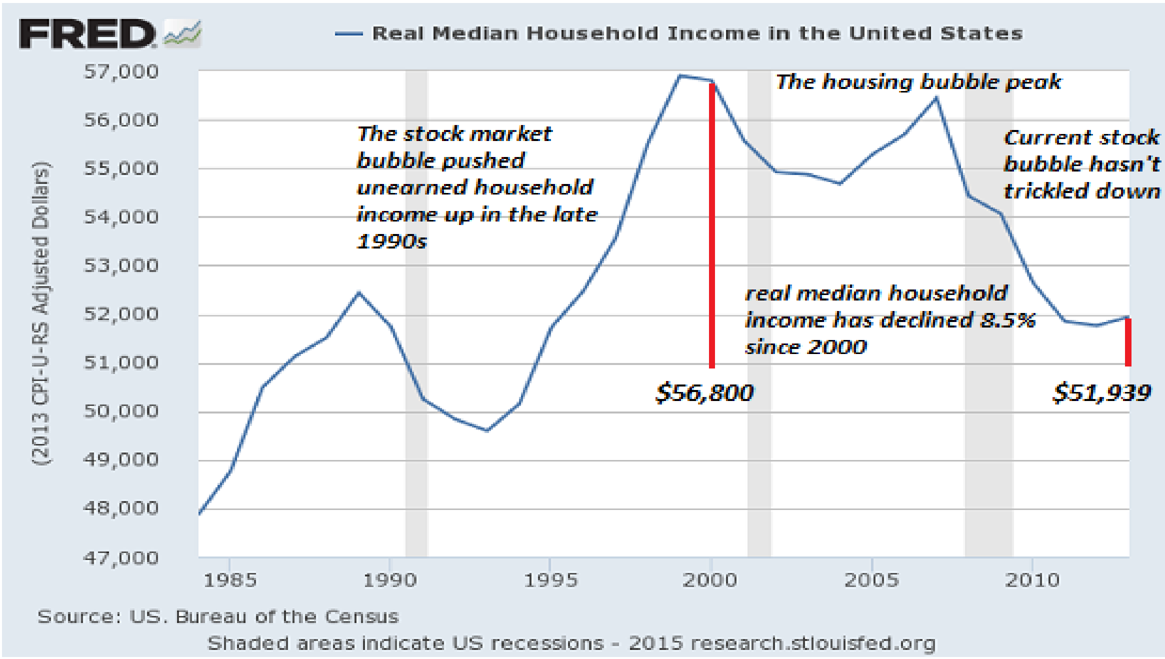
Not surprisingly given the above, industrial production is dropping quickly:



On the news we hear every day how at least the employment picture is now solid. The following chart shows the percentage of our working-age citizens who have a job.



When it comes to the employment market, the single largest factor is how much how much income workers receive. Last month we had the slowest rate of wage increase in the U.S. since at least 1982 (when they began keeping track of it). Below is a chart showing household income in the country which has not risen since 1995:



The Bond Market

There was good news and bad news for the highest-quality U.S. bonds in August. The (very) good news came during the third week when stocks had their largest losses. For the week of August 17-21, the stock market lost 5.8% while the bonds we own for our clients at Secure Retirement rose approximately 1%. This was an extremely important week to judge if our accounts are indeed positioned properly, and they passed with flying colors.

Then the stock market turned around, shooting up as mentioned above 5.6% in four days. The bond market dropped .59% last week. While not nearly as pleasant, this was not at all surprising. Investors sighed in relief that the stock market was not going to keep going down, so they sold some of their safe bonds to buy some more stocks. I'm afraid these particular investors will end up more than a little disappointed in that decision.

For those of you watching the financial news carefully you may have heard our bonds were going down because the Chinese government began to aggressively sell U.S. Treasury bonds. I'm sure they did sell some last week, but few investors seem to know the facts. According to the Federal Reserve department that tracks Treasury bonds, only 3% of what they own are over 7 years in duration. In other words, nearly all the U.S. bonds they own are short-term. This is also true for Japan and Europe. As a result, in reality there is no risk longer-term U.S. government bonds can go down in price much if at all based on international sales. (These bond prices did, however, apparently go down because some investors became scared of the Chinese bond sales. Since they weren't actually selling longer-term bonds – as they don't own them! – any price losses based on these sales should be coming back fairly soon.) Also, China sells our bonds only if they want their currency to go up against the dollar. But a few weeks ago they announced they now plan to let their currency fall against the dollar. And they need it to fall at least 20% to try to jumpstart their exports to the U.S. Last week was an anomaly, as they got scared their currency was going to fall too far too fast and would lead to more market unraveling. Still, their overall plan is to have their currency fall, which translates directly into purchasing more U.S. bonds, not less.

Conclusion

August may have been the beginning of the end of the good times for stocks. In stark contrast, during the week stocks dropped the most, our accounts had one of their best weeks in years. Nine out of our ten core funds were profitable the week stocks fell nearly 6%. We therefore sold the tenth fund (PIMCO Income) to purchase the Catalyst Hedged Futures Strategy fund. (We also sold 28% of what we had in DoubleLine Core Fixed-Income and 19% of DoubleLine Total Return. We still have complete faith in DoubleLine, but we were somewhat overweight in these two funds combined and needed some more money with which to purchase the Catalyst fund.)

At this point we are now completely prepared for whatever may come. Now I (still) cannot predict with any certainty when stocks will resume their losses. Personally I suspect the losses will resume with a vengeance in late October. Whenever it does begin in earnest, as mentioned above, the stock market will fall 40-55% - just to get back to average long-term valuations. Of course, if the world economic situation should turn worse than expected, i.e. we have a worldwide economic crisis, those losses could be higher. Either way, our accounts are positioned to not only fully protect but profit as this transpires. Mark your calendar: One year from today you will look at the fact stock market investors have lost all the gains they received from stocks for many years, while your account will have catapulted far, far ahead of the vast majority of investors.

P.S. For most clients we own a small or modest amount in a gold fund that owns both physical gold and gold-mining stocks. Gold has had a bad year thus far in 2015. In fact, it has done quite poorly since 2011. However, it was one of the best investments in the world from 2005-2010, and in 2009-2010 the gold fund we own made nearly 75% in just those two years. The key point is that it roared in 2009-2010 as the Federal Reserve Board embarked on its experimental money-printing program. At this time we believe there is an extremely high chance the Fed will end up announcing by far their largest money-printing scheme in the not-too-distant future – most likely before the end of the coming spring. Gold is highly likely to once again roar the moment the Fed hints they will again start up the printing presses.

The gold market is highly volatile and complicated. Most own some gold primarily as an “insurance policy” against major economic and market disruptions. While complicated, should you have questions about gold please contact me directly and I would be happy to explain the details to you.