Recent Market Volatility - MADE IN CHINA
Stembrook Brief – August 2015

Market Review

Given the market gyrations of the past few days, it would be perfectly normal for a rational person to feel a sense of concern or even fear. Central to our investment process, is the use of data and analysis to identify long-term investment opportunities and neutralize the negative impacts of emotion. The following Stembrook Brief attempts to outline the facts and review them in a framework of long-term, fundamental investing.

Financial markets around the world have exhibited dramatic swings in recent days and in some markets, for far longer than that. Most recently, market participants are concerned about China's growth prospects. This engine of global growth, the same one that provided a boost to the global economy during the global financial crisis, is now showing signs of slowing. Official estimates indicate that China's economy has slowed to a near 7% annual growth rate. Independent estimates put this rate at closer to 5%. Either number is well below the historical stated growth rate of roughly 9% since 1995.[1] In response, the Chinese government is moving to prop up their market and their economy. Markets are somewhat unsettled by this, considering that a few recent attempts at stabilization have done more harm than good. A massive effort to prop up shares on China's local market failed, causing investors to a.) wonder if the market would be subject to further government manipulation, and b.) to be concerned that China's seemingly omnipotent policy makers could not engineer a more stable outcome. China's subsequent surprise devaluation of its currency further spooked markets.

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Markets are also concerned about falling oil prices. Accelerating supply growth and moderating demand growth - particularly from resource intensive emerging markets - have driven oil to $38.41 per barrel, down from a high of $107.62 in July 2014.[2] Roots of supply growth can be found in the fracking revolution, which has dramatically boosted U.S. oil production. This, as well as a general market response to higher prices, drove up oil investment and production. A typical response from OPEC and particularly Saudi Arabia, would be to reduce output, limit supply and buoy prices. In what is thought to be a politically motivated act, Saudi has *increased* production, driving prices lower, not higher. Additional supply from Iraq and potentially Iran, has also driven prices lower. Individual companies, with fixed costs of developing these wells already expended, are choosing to pump more oil to make up in volume what they are losing on price, driving prices down further still. This dramatic move in oil (and energy) prices produces winners and losers. Lower oil prices are generally a positive for manufacturers and consumers. As the cost of production falls, corporate profits rise. Consumers have more money to spend elsewhere, as their utility and gasoline bills fall. On the other hand, oil producing companies and countries are hurt, some dramatically, by such a drop in oil prices. For the time being, markets are focused on the latter more than the former.

Another destabilizing force is the expectation that the U.S. Federal Reserve will begin normalizing (raising) short-term interest rates in September or December. While it is debatable as to whether this will be a plus or minus for capital markets and the economy, markets don't like uncertainty and have thus added this to their list of worries.

On a technical note, August tends to be a historically volatile month as what would otherwise be small moves can be magnified by lower volumes (read market participants are on the beach instead of at their desks). This technical factor has not helped matters.

When we look at the world from the perspective of fundamental factors that drive returns, equities remain the best of the lot for long-term investors. Further, with higher yields and lower prices, value oriented stocks (those with lower valuations) represent particularly attractive investments at this point in time. This is not to say that equities will not be subject to market volatility; they most certainly will. However, stocks still represent the best long-term place to make a reasonable return over and above inflation, for those who can remain invested for at least one market cycle. Today, the earnings yield - or the profit a company makes for its shareholders relative to its share price - is 4.9% for the average company in the S&P 500. The earnings yield on developed European and Pacific equities are 4.8% and 7.1% respectively. With recent price drops, the earnings yield on the average emerging markets company is 8.4%. These numbers can be compared to the 0% you can earn in the bank or roughly 2.5% yield paid to intermediate term bond investors. Valuations are compelling for long-term investors.

Equally important, is to consider how you are positioned on a strategic basis. Through your and our extensive efforts, every Stembrook client has a customized Strategic Investment Plan that outlines financial needs and wants, short-term liquidity requirements, investment horizon, risk tolerance, and other client-specific factors. These critical factors are used to craft a unique portfolio that is tailored to your particular situation. Your portfolio is intentionally created to balance your return requirements with your willingness and ability to withstand market volatility.

We continue to view the world in terms of investment fundamentals because these factors have proven to be most predictive indicators of long-term returns in market history. Short-term volatility is inevitable, but our long-term perspective and disciplined process will keep us focused on generating strong investment returns. Further, they help us focus on the opportunities that are presented in times of market volatility.

Please don't hesitate to contact me if you have a particular concern or question about this brief or about current markets, in general. Also, please contact me as soon as possible if your current state of affairs has changed, as it may be reason to re-assess your Stembrook Strategic Investment Plan.

As always, I thank you for your trust and appreciate your continued confidence in our investment management and advice.

Sincerely,

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Endnotes

1, 2 Source - Bloomberg

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