MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

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The benefits of portfolio diversification are well established in financial theory and in practice. Holding a mixture of assets that are weakly correlated and with varying degrees of risk clearly improves an investor's results over the long term. Over the short term, however – periods of weeks or months – holders of these assets frequently have found themselves crowding the exits at the same time. When the market environment switches to "risk-off", as it did in August and September, correlations rise and nothing is left unscathed.

The US equity market, as measured by the S&P 500 Index, ended its nearly three-year run of uninterrupted quarterly gains, falling by 6.9% in the period ending September 30. This was the worst quarterly performance since 2011. Losses were widespread, impacting every sector, geography, and asset class; some "lowlights":

Price Change June 30 – September 30, 2015:

Small caps (Russell 2000 Index) -12.2%
Biotech (NASDAQ biotech index) -18.0%
Master Limited Partnerships (Alerian MLP Index) -19.8%
Emerging Markets (MSCI Index) -17.3%
Europe (Dow Index) -10.7%
Asia (Dow Index) -17.7%
High Yield bonds (Barclays Index) -7.2%
Crude oil (West Texas Intermediate) -20.7%
Commodities (CRB Index) -13.5%

Among domestic sectors, only utilities – previously a significant laggard – showed gains (up 7.3%). Energy stocks (down 18.1%) led the decline again, reflecting the ongoing weakness in oil prices. Even previously strong leaders, such as health care stocks (down 11.0%), succumbed to selling. US Treasuries (up 2.0%) provided a haven – all indicative of a simultaneous flight from risk by investors. Absent a fourth quarter rebound, US stocks are now poised for their first down year since 2008.

A setback such as this can hardly come as a surprise, as the market had proceeded for over 1400 days without as much as a 10% correction – the third-longest such streak of all time – compared to an average span of only 514 days. We also noted in the last issue of *Consilium* that fewer and fewer stocks were participating in the market's advance, a reliable signal of an aging market cycle. This may have been a market that was "looking for an excuse" to decline at a time of year that always seems conducive to drama.

Sources: Baseline, The Wall Street Journal, FactSet, Goldman Sachs

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An excuse was provided on August 11, when China devalued its currency, the renminbi. Although the magnitude of the devaluation was not significant – just a few percent – the message from China's central bank was clear: economic growth had slowed to an unacceptable pace, and the currency needed to weaken to bolster the country's competitiveness in export markets. Official data has confirmed what commodity markets had suspected: China's economy is growing at its slowest pace in over six years. As an important engine of global commerce, this slowdown has had nearly disastrous effects on China-dependent exporters such as Brazil and South Africa. And it has already hurt American firms with substantial exposure there – Caterpillar recently announced that it expected a 20% revenue decline over the next two years due to persistent weakness in China and other emerging markets. It also implemented a restructuring plan featuring 5,000 job cuts.

Is the US economy susceptible to China-generated weakness? Probably not, according to analysis by Goldman Sachs, which suggests direct and indirect effects amounting to no more than 0.11% - 0.48% of GDP. And prior to these developments, the US economy appeared to be on solid footing. But less than a year after it became clear that growth was set to accelerate – a view that drove the Federal Reserve's decision to end "quantitative easing" – that outlook is being called into question due to external factors. The Fed acknowledged as much in remarks following their Open Market Committee meeting last month, when they decided to forgo an increase in the overnight Fed Funds rate – which remains stuck at 0% after nearly seven years.

Our view is that this episode is merely a growth "scare" at a time when the market was primed for a setback of some kind. But we cannot be completely certain of that outcome, particularly as most of the world's central banks have already exhausted their stimulus options. In the interim, the US equity market may fail to make much forward progress until valuations drop to more attractive levels, or strong earnings growth reasserts itself, or both.

G:\When economic uncertainty rises, markets become unsettled. But most of the stocks held in MCC client portfolios should be able to grow on a long-term basis even if the economy were to weaken temporarily. On the other hand, the average bond offers safety, but only minuscule return potential at current levels. Fortunately for our clients, their bond portfolios have proven to be quite valuable and resilient in the recent turmoil. We conclude that while conditions must be closely monitored, a dramatic reallocation of assets appears premature at present.

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