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SUMMARY

The declines in stock prices this past August, as well as the start of this year, reflect instability originating in China, which is a bubble now bursting. Other emerging markets and industries are deflating with it. Specifically, the commodities "Supercycle" that we've seen over the past decade is over. Secondary effects are now being seen in the credit markets. Concerns about credit availability as well as bank soundness are spilling in to equities as investors worry about the third and fourth iterative effects. We suspect that most of the damage will remain confined to China, emerging markets dependant on commodities, and certain industries, just as the end of the Japanese bubble in 1989/90 was confined primarily to Japan.

The data indicates that the U.S. will continue to grow moderately in the quarters ahead. Earnings for the S&P 500 are forecast to expand in 2016 now that the foreign exchange impact is washing out. Additionally, stocks are materially undervalued in light of the low level of inflation and prices should be significantly higher in the 2-to-5 year timeframe because of the good values and higher earnings. Nevertheless, stocks volatility is expected to remain high in the months ahead because of the uncertainty originating from Asia. Concern about the European banks is also weighing on stock valuations. A further decline in stocks is a possibility in the near term, but we think a swift bounce-back would likely follow.

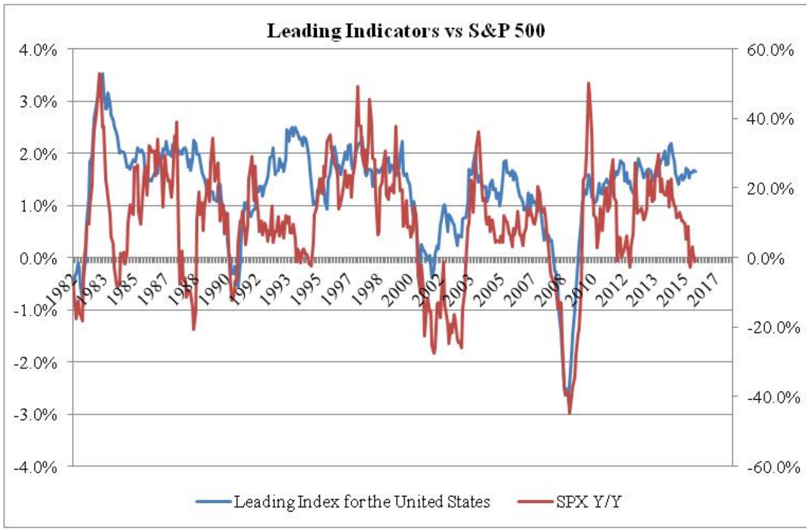
US ECONOMIC INDICATORS REMAIN POSITIVE

The downward move in stock prices this year has raised fears of recession, but the numbers don't support that idea. The weak economies of Brazil and other important foreign markets have impacted the U.S. Exports have fallen from a peak annual rate of $2.36 trillion (13.5% of GDP) in the third quarter of 2014, to a rate of $2.21 trillion (12.2%) in the fourth quarter of 2015, reflecting both the strong dollar and weak demand in foreign nations. Even more important, corporate profitability has suffered because of softness or contraction in many countries. It varies, but about a third of profits for the S&P 500 originate from foreign operations. Despite these negatives, the following indicators still point toward moderate expansion for the U.S. economy:

Chart 1

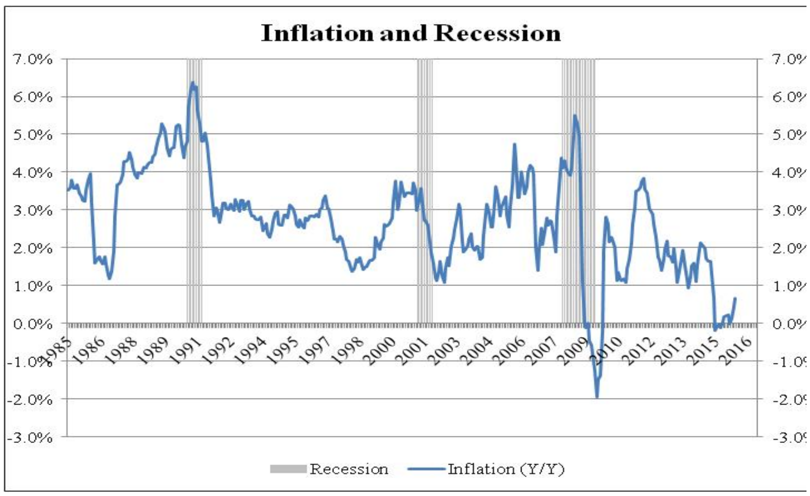
The ISM Manufacturing New Orders Index stood at 51.5 at last reading. Despite all the headwinds facing U.S. manufacturers, a rate above 50 indicates growth ahead.

Chart 2



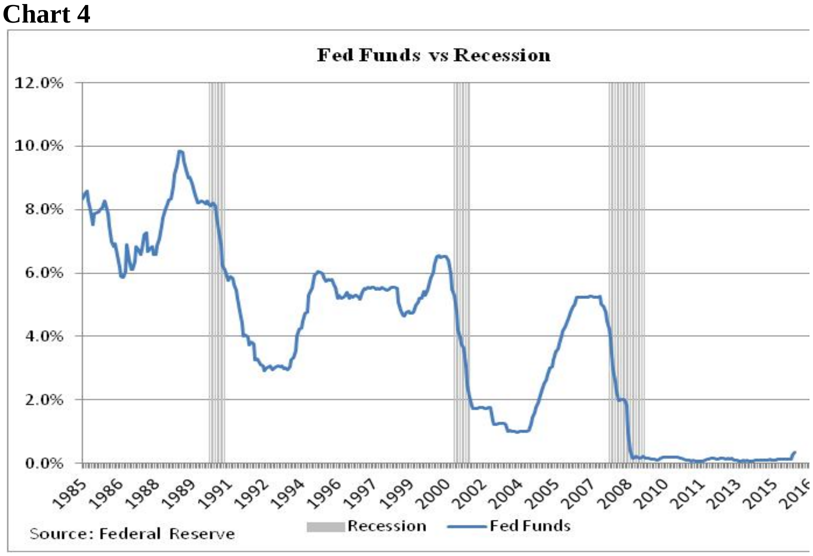
The Index of Leading Indicators (left scale in the chart) remains very positive despite the drop in the S&P 500. This divergence is not unprecedented. Stocks also went negative in 1994 while the Leading Index was positive. In 1995 the S&P 500 rose 34%.

Chart 3



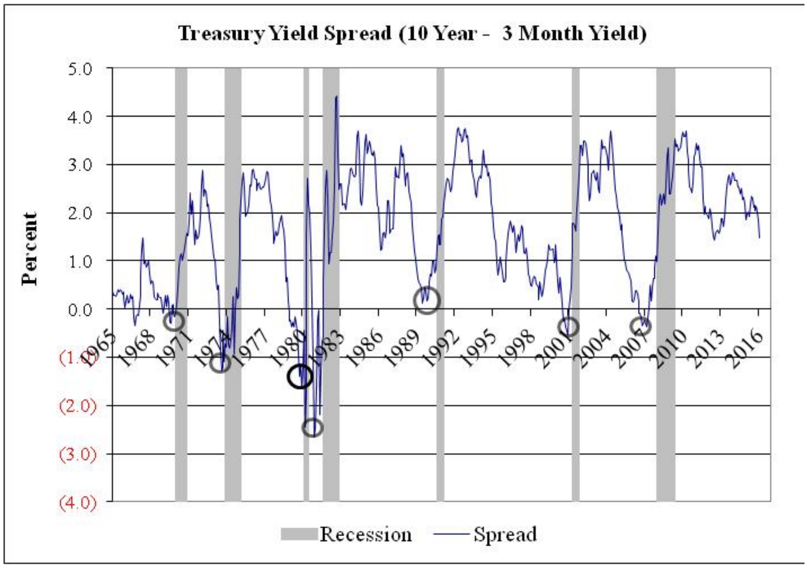
A spike in inflation has typically preceded recessions because inflation both signals excesses in the business cycle and the need for monetary policy to be tightened. Inflation is not now an issue.

Chart 4



The Fed had been raising overnight bank lending rates (the "Fed Funds" rate) for a significant period before each of the last few recessions. The Fed's December increase of 0.25% barely registers.

Chart 5



The shape of the U.S. treasury yield curve can be measured by subtracting the yield on 3 month bills from the 10 year bond. As seen in the chart at left, the yield curve was flat or negative prior to past recessions. The curve has flattened recently as the yield on 10 year bonds has declined, but still remains positive.

THE CHINA COMMODITIES IMPLOSION

The central factor impacting markets now is the end of the China commodities "Supercycle." Early in the last decade China began a period of rapid growth founded on a government organized industrial policy that feature huge spending on infrastructure, industrial expansion and residential construction. The Chinese have been producing more steel than the U.S., Europe, Russia and Japan combined and there are many other signs of extreme excess. This huge surge in China led global businesses to expand investments in new capacity, especially in emerging markets and industries that provided raw materials such as copper, iron ore, and oil. Rising prices during the past ten years resulted in what has been called a commodities Supercycle, which has clearly ended. But global overinvestment stretches wider than to only commodity producing industries.

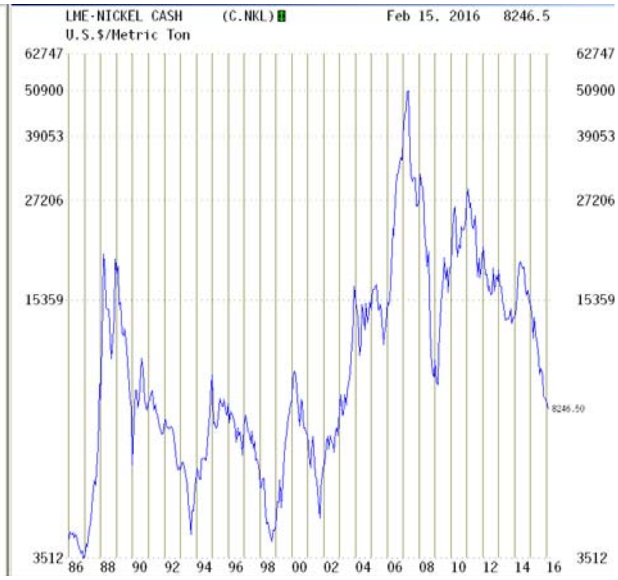
The end of the commodities Supercycle is evident in the Charts. China's importance as a major economy really exploded onto the world early in the last decade. China not only grew in size to displace Japan as the world's second largest economy, it was growing at very high rates that stimulated capital investment in many parts of the world as investors sought to profit from rising demand and prices.

Chart 6

Chart 7

Chart 8

Chart 9



China is the common factor in the charts above, and it's a good bet that the excesses that are evident will take considerable time before they are unwound. The rise in copper prices (Chart 6) incentivized mining companies like Freeport-McMoran to spend many billions of dollars to construct super mines, with a lot of that capacity only coming on now. The same is true for oil production and other commodities like iron ore and nickel (Chart 9), which is used in the manufacture of stainless steel. It's also interesting to note the bubble and subsequent collapse in the Baltic Dry Index (Chart 8). This index essentially plots the cost of shipping freight around the world. In the middle of the last decade, shipping rates shot up. This attracted big investment in new ship construction. Now the world is awash in shipping capacity at the same time that trade is softening. Shipping rates have now collapsed to unprecedented levels.

Deep value investors may be tempted to allocate capital to some of these beaten down areas, but we think it's too soon. Unfortunately, the supply of oil, copper, ships, etc takes time to build in response to new demand from a behemoth like China, and it will take considerable time for supply to adjust to slackening demand. Bankruptcies are coming. Prices will likely be volatile partly due to speculation, but supply, based on big fixed investments, and other fundamentals will almost certainly take some years to adjust to the end of the China bubble.

CREDIT MARKETS SHOWING STRESS

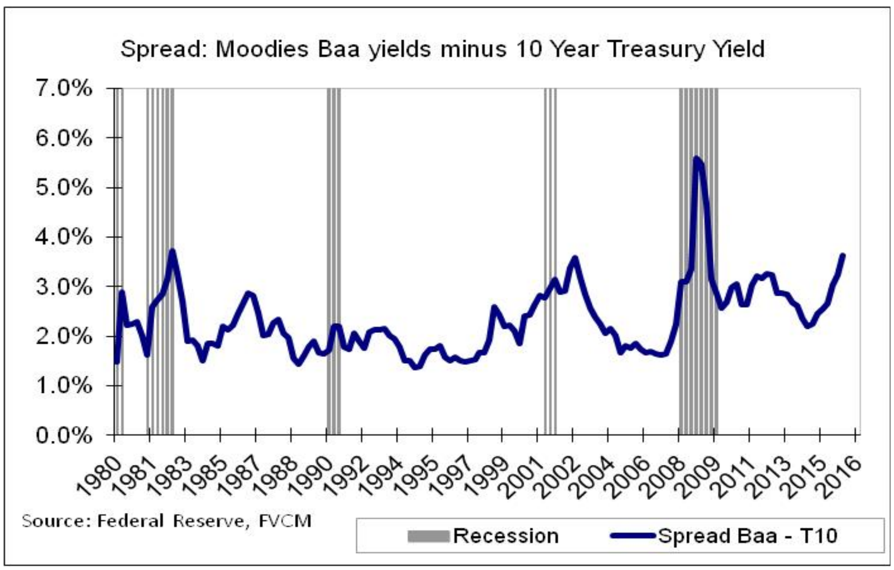
The vast overinvestment that resulted from the China bubble and the commodities Supercycle is now creating stresses in the credit markets. In the U.S., spreads on high yield bonds in the energy sector have exploded from about 4% over U.S. treasuries to 14%. Mining, steel, shipping and other closely affected businesses have seen similar moves. But the damage has not been limited to the junk markets. Bonds rated Baa by Moody's, which means they are "judged to be medium-grade and subject to moderate credit risk," have seen spreads widen sharply as well (see Chart 10).

Credit markets are also under stress because of risk and uncertainty regarding dollar denominated debt owed by foreign borrowers. Many foreign businesses, which typically face higher rates of interest to borrow in their home currencies, have been able to get inexpensive financing through debt denominated in dollars. In this way, the easy monetary policy of the Fed during recent years was an easy credit policy for many foreign borrowers. According to the Bank for International Settlements (BIS), there is now more than $10 trillion in USD denominated debt owed by non-bank borrowers who have a different home currency. The majority of this debt has been issued in the Emerging markets, including

China, which has $1.2 trillion in USD denominated debt. Note: about ¾'s of total foreign USD debt, including bonds, was extended by foreign banks and other foreign institutions. Even more, 80% of dollar loans issued by banks were issued by non-US banks. For example, the BIS estimates that Chinese banks have made dollar loans of nearly $1 trillion dollars. This is obviously dangerous, especially since the dollar's foreign exchange value has risen. Brazil's Petroleo Brasileiro SA has issued more than $40 billion in dollar bonds since 2008. Clearly they will have difficulty paying this dollar debt back with energy prices down sharply. Other companies with dollar debt, and which earn revenues in local currency, are under even greater stress because of the dollar's strength in the foreign exchange markets. The Brazilian Real has lost more than 60% of its value against the dollar since mid-2011. The following links can be followed for more information on this subject:
http://www.bis.org/publ/work483.pdf
http://www.bis.org/publ/qtrpdf/r_qt1512e.htm

Other very visible signs of credit stresses include the very poor performance of bank stocks, which have sharply underperformed the market in general. The U.S. banks, which have capital to asset ratios in the 9%-to-12% range (Bank of America = 10.9%), are considered to be very well capitalized, but there is much concern about counterparty risk with European banks in particular, which have cap ratios of about 8% (Deutsche Bank = 4.2%). Nonperforming loans in Europe are also much higher than in the U.S. The likelihood is high that the banks will have to increase reserves for bad loans in the months and years ahead as the decline in commodity prices, and the rise in the dollar's foreign exchange value ripples through the global economy. Unfortunately, there is no good way to know how the chain of events will travel. We consider risk in financial stocks to be high.

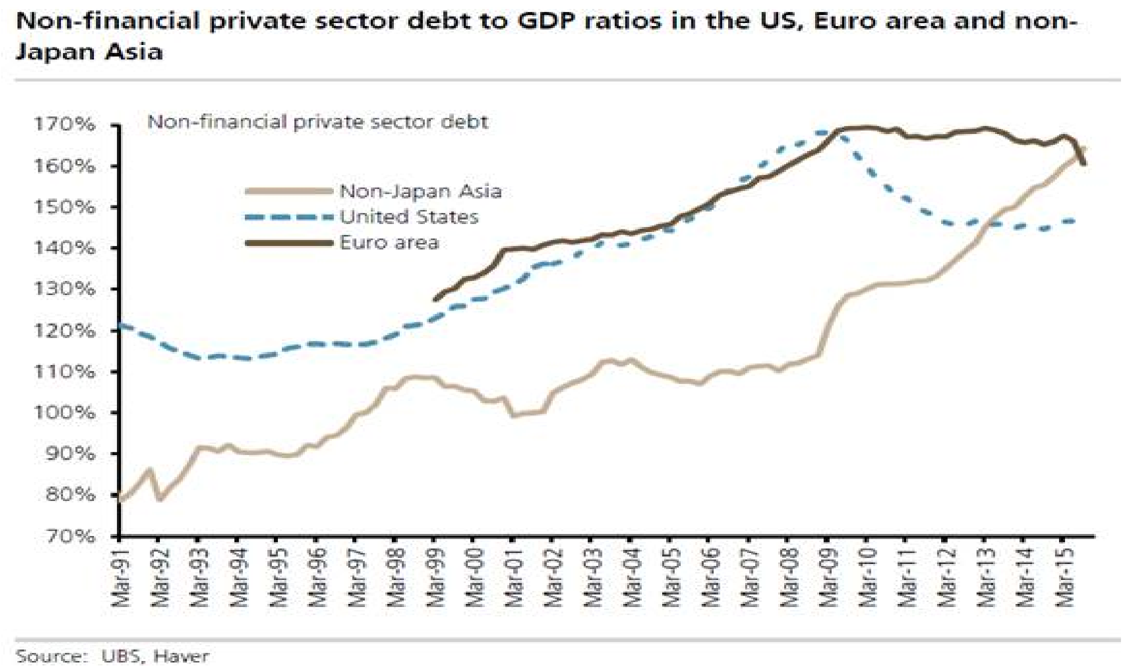
Chart 10



TOO MUCH DEBT, TOO FEW DOLLARS

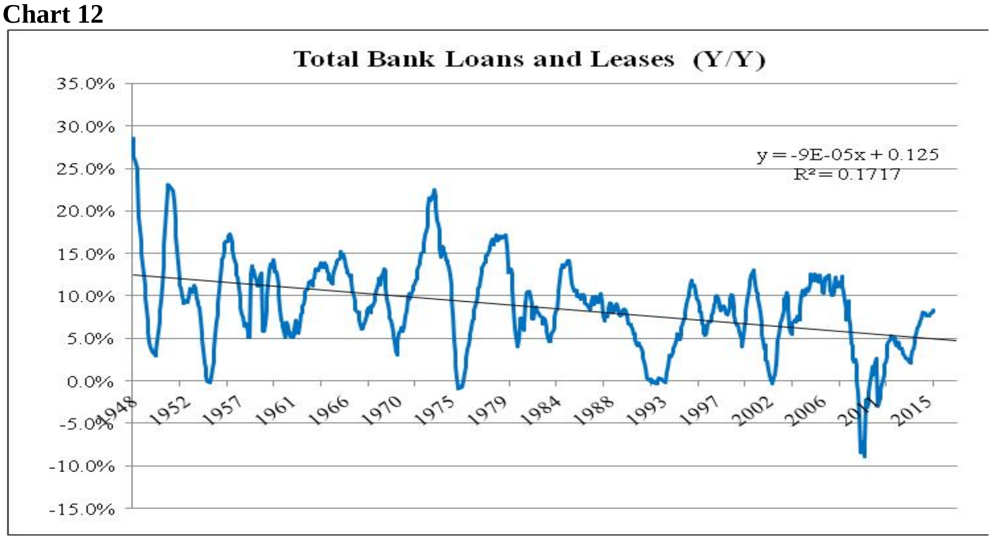
The negative moves in the debt and equity markets this year not only reflect the collapse in commodity prices. Investors are well aware of the high degree of leverage worldwide and the greater risk inherent in an indebted global system. Western growth in nominal spending has been fueled by debt creation for many decades. Now, the Chinese and other East Asians have joined the ranks of the over-indebted (see Chart 11). There is probably no hard limit to the amount of debt that any one person or business or country can sustain over some period of time. However, incremental increases in leverage become more difficult to sustain as debt rises in proportion to income. Furthermore, shocks like the 2008 financial crisis change attitudes and appear to have reduced people's willingness to use debt. This is evident in the low level of home ownership in the U.S. despite the gains in employment. People have become more conservative and would rather rent. So, high debt levels slow the pace of new lending and spending. The high level of debt also explains why interest rates are in secular decline. People and businesses get to a point where they can't/don't want to take on more debt and lenders have to offer increasingly attractive terms in order to entice additional borrowing.

Chart 11



Bank loans and leases in the U.S. have recently experienced a strong cyclical bounce, but the long term trend is down. After WWII, total household debt in the U.S. was low—only about 25% of GDP, versus 78% now (the peak was 98% in 2008). From the low post-war base, loan growth was rapid in the early years as soldiers returned home, went to school, started families, and bought houses. Over the decades, as debt levels rose, trend in new loans has gone from a 12.5% annual growth rate to only a 5% annual rate (see Chart 12). Nonetheless, bank loans and leases were up 8.1%, year-over-year, as of January 2016, thanks to a cyclical rebound. The current above trend growth in loans could be sustained for a few more years, but eventually it will hit a barrier of high debt and again turn negative.

Chart 12



Source: Federal Reserve, FVCM

Even though bank lending may decline again (see Chart 12) due to an unwillingness to borrow on the part of an indebted public, the Fed can still stimulate spending by creating money through asset purchases (QE). If the Fed buys a bond from a bank, the Fed gets the bond and the bank gets a deposit at the Fed (bank reserves). Bank reserves do not directly impact spending by the public. But when the Fed buys a bond from the non-bank public, a bank demand deposit (M1 money) is created. The Fed essentially takes the treasury bond out of the public's hands and replaces it with money. The Fed had to resort to quantitative easing (QE) after the start of the financial crisis because bank loan growth went negative in 2008/2009. QE helped put money and spending power in the hands of the public.

Nominal spending has been growing slowly because there is too little money, as well as too much debt. In 1959 there was $4.90 of debt (Total Credit Market Debt) for every $1.00 of bank demand deposits and cash in circulation (the M1 money supply). Now there is nearly $20 of debt for every dollar of cash out there. It appears that we have come to the end of a multi-decade, secular expansion in debt relative to money. As a result, it appears that future growth in nominal spending will have to be supported more through QE and less through the bank lending process.

Central banks can manage spending growth and inflation, but they have little or nothing to do with real growth. This is why so-called structural reforms are so important. Barriers to business formation, laws that restrict labor flexibility, unreasonable regulatory constraints to business operations, and high and foolish taxes all impact the "supply-side" and can lead to economic stagnation regardless of what any central bank does. If central banks could produce real growth, Venezuela and Zimbabwe would be paradises. With the smart or foolish laws affecting business as a given constraint, central banks can only support or hinder real growth by managing nominal spending. That is all. This should be some source of concern since, as we've seen in Japan, it is easy to take strong central bank action, yet difficult to get politicians to support reforms that will impact constituents currently benefitting from government support and protection. Germany has shown that some reform is possible, but it is difficult.

U.S CORPORATE EARNINGS TO REBOUND

Sales and revenue for the S&P 500 (SPX) declined 2.4% in 2015. While the energy sector (previously 12% of the index) was a factor, the decline was mostly due to the effects of the strong dollar. Foreign sales and operations account for more than a third of the SPX's sales and earnings, and the substantial rise in the trade weighted value of the dollar's foreign exchange value depressed foreign results after being converted back in to dollars. As you can see in Chart 13, the dollar's rise occurred from about mid-2014 though the first quarter of 2015 and has since flattened out.

Increases in sales and revenue for the SPX are already underway. The downward pressure on currency translations, on a year-over year basis, should be washed out by mid-2016. In fact, revenues were impacted the most in the 2015 second quarter when they were down 9%, year-over-year, and have since improved. In the 2015 fourth quarter, revenues were already up 2.8%. Revenue growth for the SPX tends to closely track the growth in U.S. nominal GDP (see Chart 14), with much of the difference being due to the effect of foreign operations. In recent years revenues have grown faster than the domestic U.S. economy because of strong gains made by American businesses in emerging and other foreign markets. However, you can see in 2015 that revenue growth was below GDP growth. That is now reversing and we expect sales and revenues to grow in the range of 3% and 5%, despite a continued drag from the energy sector.

Chart 13 Trade Weighted US Dollar

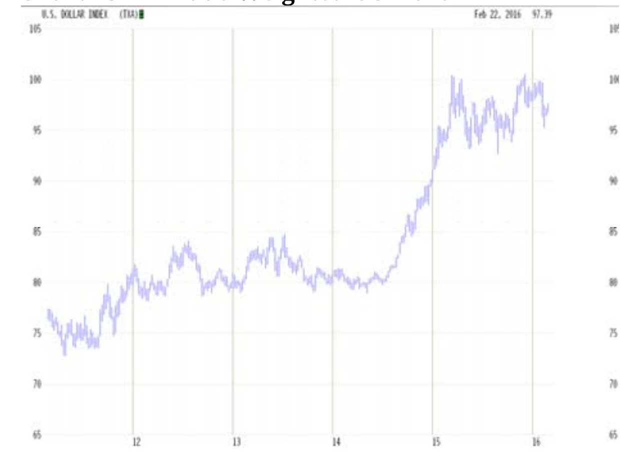
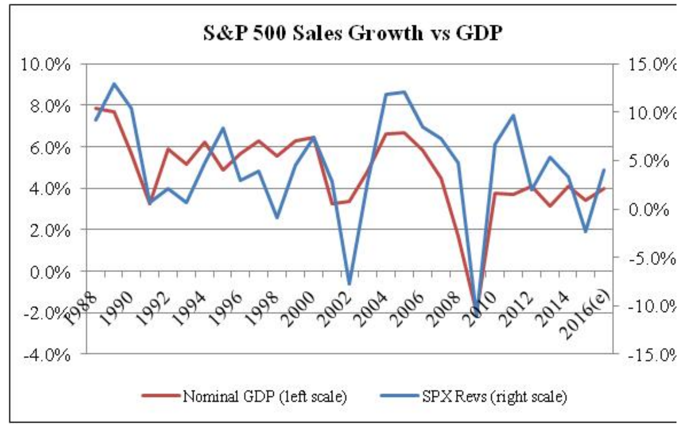


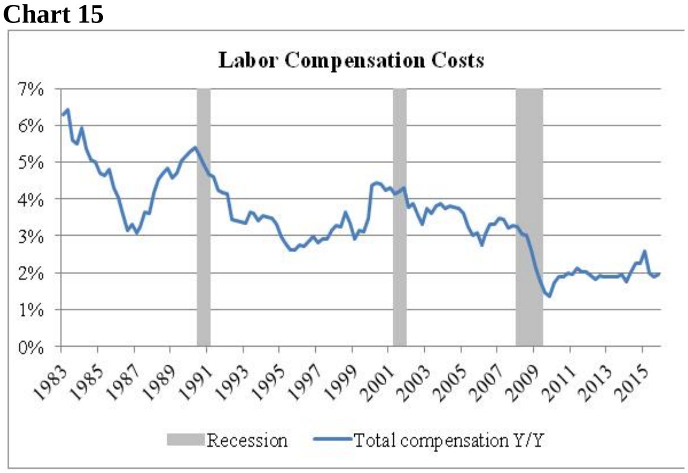
Chart 14



Source: FVCM, Federal Reserve

Operating earnings for the S&P 500 fell about a percent last year, while the more conservative GAAP earnings fell 12%. Gains are expected going forward. As just discussed, the negative effect of the dollar's rise in 2014-5 is now mostly washed out and revenues are rising. Total labor compensation costs have been growing at a fairly consistent rate of about 2% (see Chart 15) despite the fact that the unemployment rate has fallen to 4.9%. Unemployment may have to fall considerably more before labor costs really accelerate. We do not see any upward risk from financing costs either. Operating profit margins should hold about steady (see Chart 16) or even widen a bit, and operating earnings are forecast to rise to 124 in 2016 from the 117.97 in 2015. GAAP earnings, which includes substantial charges in the energy sector as well as other non-recurring costs, took a steeper hit in '15 and the bounce back should be even greater in 2016 (see table 1).

Chart 15



Source: FVCM, Federal Reserve

Chart 16

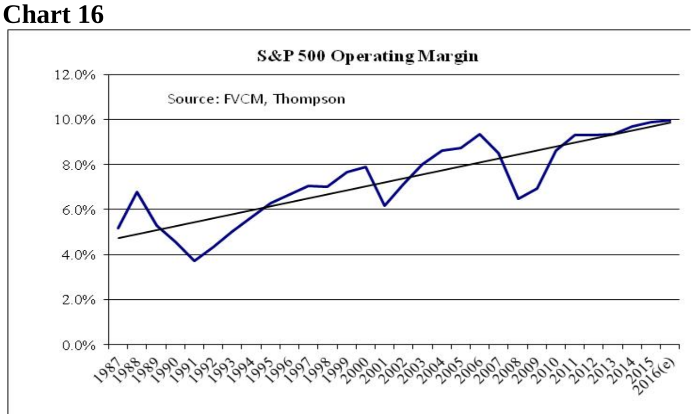


Table 1

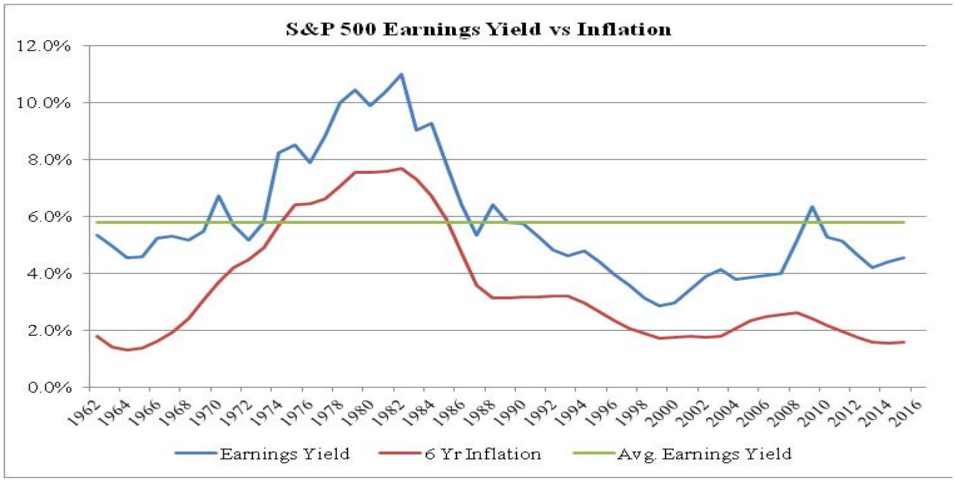
	Operating Earnings	GAAP Earnings	GAAP Trailing 6
2000	56.34	50.00	41.38
2001	45.17	24.69	39.84
2002	48.13	27.59	37.98
2003	55.55	48.74	39.48
2004	66.99	58.55	42.96
2005	76.29	69.93	46.58
2006	88.17	81.51	51.84
2007	86.23	66.18	58.75
2008	68.63	14.88	56.63
2009	65.26	50.97	57.00
2010	86.73	77.35	60.14
2011	102.76	86.95	62.97
2012	104.57	86.51	63.81
2013	110.66	100.20	69.48
2014	118.64	102.31	84.05
2015	117.97	90.40	90.62
2016(e)	124.00	103.11	

Source: FVCM, Thomson Baseline, Standard & Poor's Corp.

STOCKS ARE CHEAP: THE STUPIDITY OF AVERAGES

Yes, the P/E ratio for the S&P 500 is above the historical average, but stocks are still cheap because of the low level of inflation. It has become a common refrain in the press, and even among some influential economists, that stocks are expensive because the P/E ratio is above the historical average. This is incorrect. P/E ratios are high for the same reason that bond yields are low: Inflation is like a poison that shrinks valuations. But with inflation running persistently and convincingly low, it's time we accept the fact that P/E ratios should remain high. In Chart 17 below, we compare the 6 year trailing earnings yield (E/P rather than P/E) of the S&P 500, with the 6 year trailing level of inflation. We use the 6 year period because people's expectations for the future is tied to the recent past, and 6 years is statistically the best fit. When inflation rose in the 1970s, the earnings yield on the S&P 500 rose as well—this is the same as saying that P/E's fell. And starting in the 1980s, when inflation declined, the earnings yield declined (P/E's rose). This makes perfect sense. Investors assign a lower value to future earnings when it will be eaten by inflation, and a higher value to future earnings when inflation is low. The current earnings yield is below the historical average, but this means nothing unless inflation returns to the long term 3.5% average. Is that possible? Yes, but there are no signs of it happening soon.

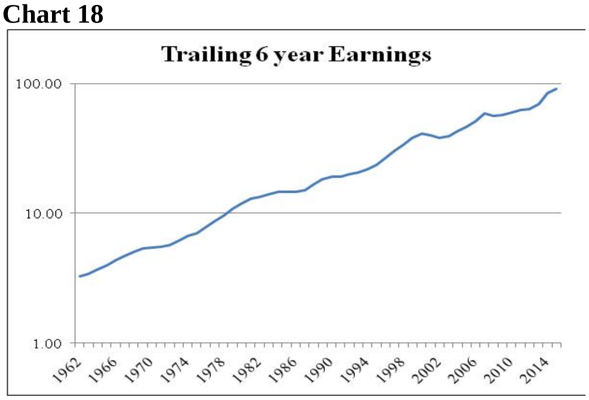
Chart 17



Source: FVCM, Federal Reserve, Standard & Poor's Corp.

Based on the trailing 6 year inflation rate of 1.6%, our regression model indicates a fair value of the S&P 500 of 2295, or roughly 18% above the current level. Our model uses trailing GAAP earnings (see Chart 18) to smooth out the effects of the business cycle, a method originally proposed by Graham & Dodd in their famous 1934 text "Securities Analysis," and also more recently popularized by Robert Shiller. However, our model compares this cyclically adjusted P/E against historic inflation patterns in order to determine "fair" cyclically adjusted P/E (see data in Table 2).

Chart 18



Source: FVCM, Standard & Poor's Corp.

Table 2

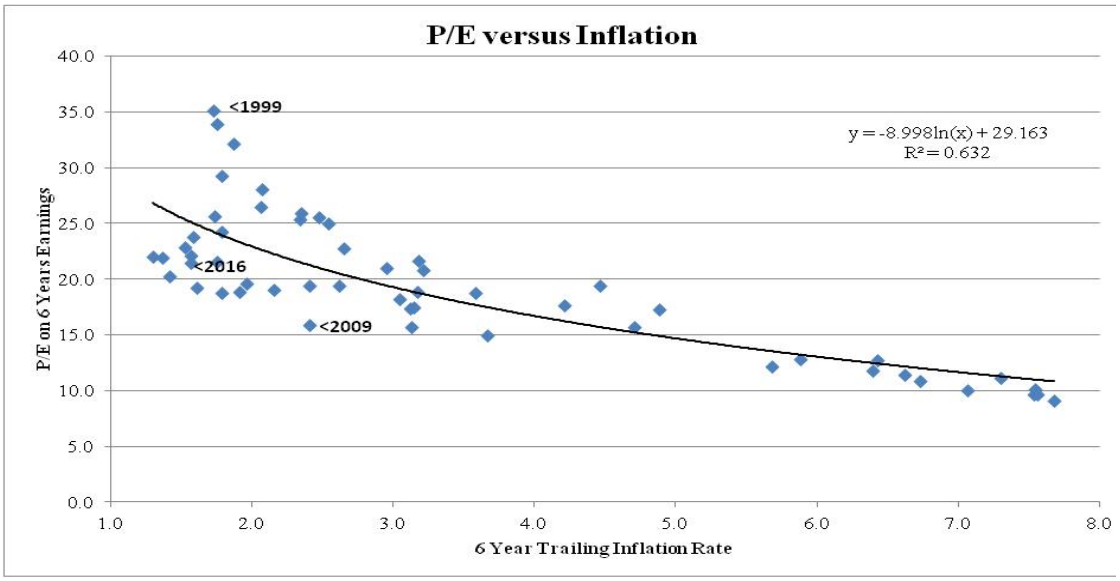
S&P 500 Fair Value

Trailing 6 Year Earnings (2015)	90.62
Trailing 6 Year Inflation (%)	1.6
Fair P/E on Trailing Earnings	25.3
Fair S&P500	**2,295**
Earnings GAAP 2016(e)	103.1
Earnings Operating 2016(e)	124.0
P/E 2015 GAAP Earnings (target)	22.3
P/E 2015 Operating Earnings (target)	18.5

Source: FVCM, Federal Reserve, Standard & Poor's Corp.

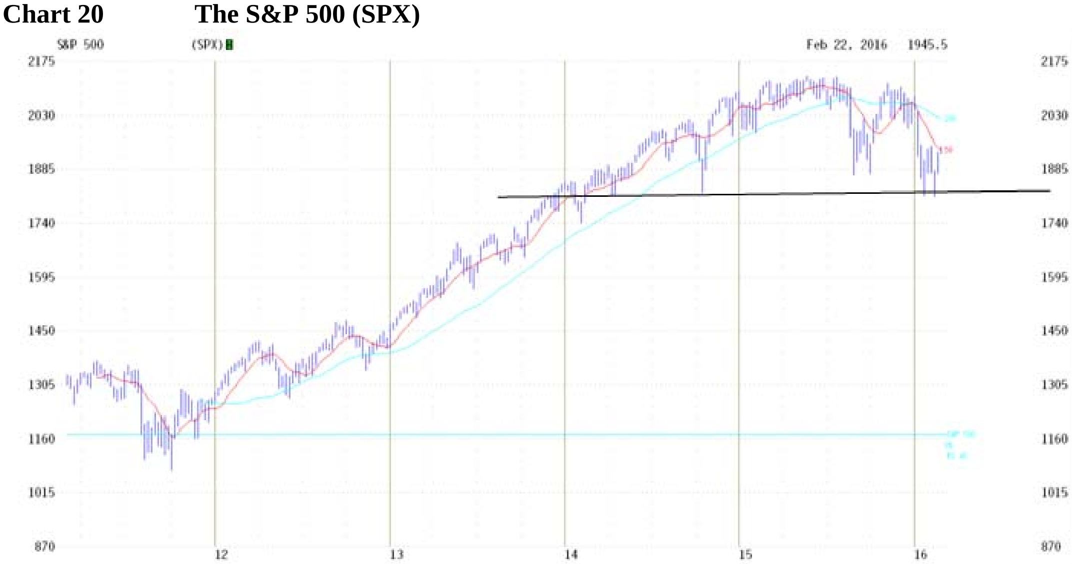
Stocks are cheap, but that does not guarantee that prices will rise in the near term. The line in Chart 19 is our regression model that provides the "fair value" of the S&P 500 at various levels of inflation. The dots represent the actual historical P/E's calculated in this manner over the past five decades. We've marked the 2016 data point which is below the line, and thus indicates the undervaluation. We also included 1999 and 2008 for comparison. Models like this are useful because they indicate whether you are getting a good deal in the stock market, but they don't necessarily mean you won't get an even better deal next month. If the model was perfect, all the dots would sit on top of the line. The dispersion around the line reflects the fact that investors are buying and selling stocks for reasons other than valuation. Back in 1999-2000, the euphoria of the Internet and other new tech developments drove speculation up and the S&P 500 became 40% overvalued at that time. Today, as we have discussed, the collapse of the China commodities bubble has inflated investor concerns and driven the market toward a 20% undervaluation.

Chart 19



Source: FVCM, Federal Reserve, Standard & Poor's Corp.

Chart 20 **The S&P 500 (SPX)**



Stocks may be cheap but the S&P 500 is down about 5% this year and 9% since last May (see Chart 20), and volatility is expected to remain high. We don't expect investor skittishness to dissipate until the currency, commodities and credit markets stabilize. China remains a key focus because of the substantial capital outflows from that country and the possibility that they could be forced to significantly devalue the Yuan. Investors are also uncertain about credit losses due to the commodities bust and are looking for greater clarity. Because stocks are inexpensive, we think investors with a two-to-five year horizon should do quite well. Any further declines in market prices represent a good buying opportunity. Investors who may need cash in the months ahead, however, may want to step aside. High levels of uncertainty provoke high levels of volatility and almost anything can happen in the short-run. We also can't rule out a spike upward in prices if the China issues turn out better than it looks today.

We recommend investors focus on businesses less affected by the China/commodities implosion, and also take heavy account of balance sheet strength and trading liquidity. We have moved away from any bank stocks or more risky financial stocks until credit market risk becomes more stable. As already mentioned, it will likely take years for the over-supply of many commodities and related industries like shipping are corrected, and we will mostly avoid those areas for now. Probably the best opportunities will be in businesses with decent growth opportunities and which focus more on the domestic U.S. markets. Ultimately, we think that the U.S. will move past the China implosion of 2015/6 the same way the U.S. moved past the Japanese implosion in 1989/1990. Just hold on tight for a wild ride!
