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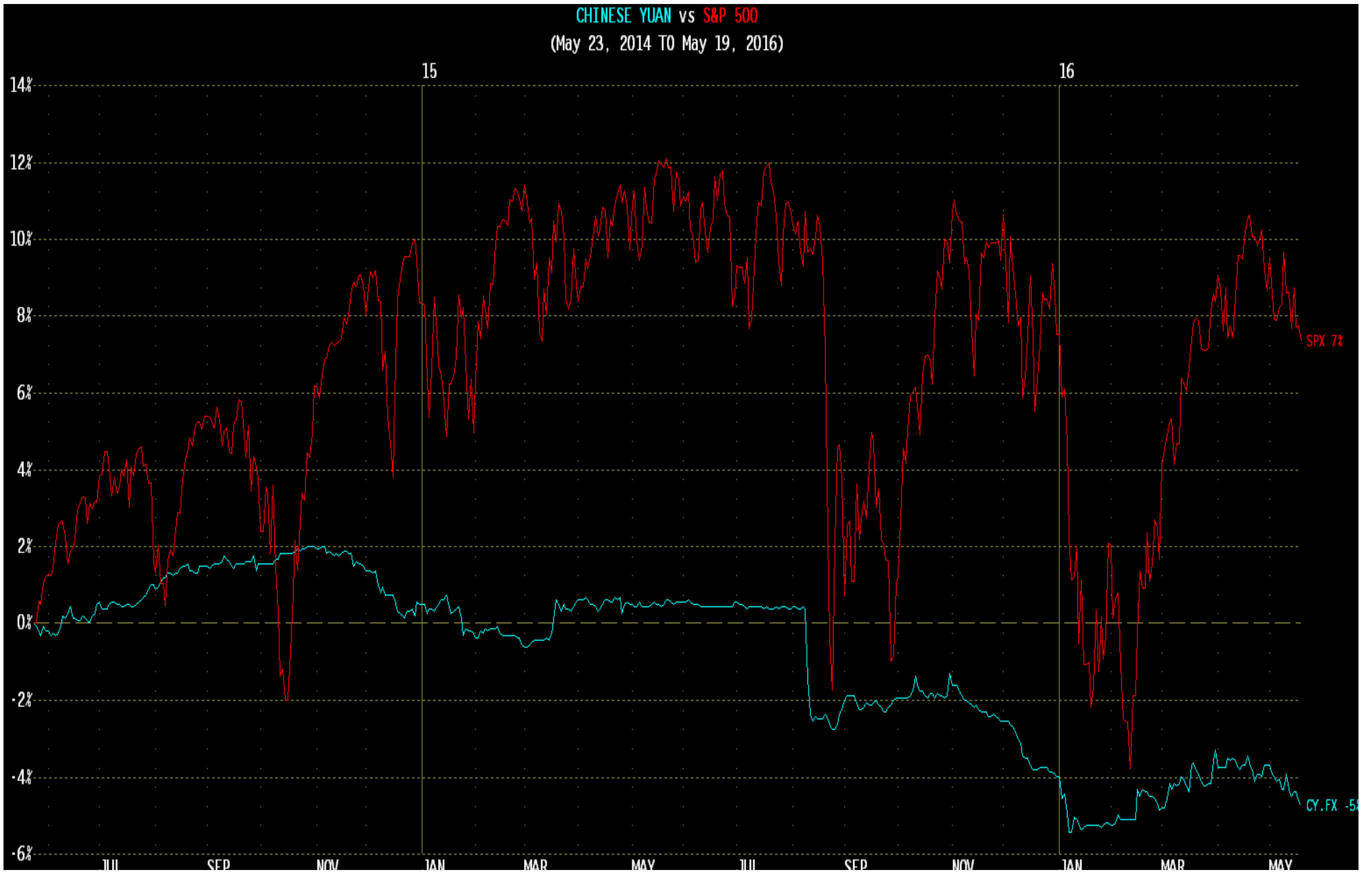
Chart of the Day: Stock Investors Nervously Follow China

CHINESE YUAN IN BLUE & STANDARD & POOR'S 500 IN RED



1. As you know, the Standard & Poor's 500 (SPX) took a sharp hit when the Chinese central bank allowed the Yuan to depreciate last August (see Chart above).
2. The market and the Yuan recovered until November 3, 2015 and then both began heading south again into the New Year.
3. The recent move higher in the SPX--starting around February 16--again very neatly coincided with a rally in the Yuan.
4. It's deja vu all over again: The recent high on the SPX on April 20th closely fits the beginning of the recent weakening in the Yuan; this is not a coincidence.

China's problems have a few parallels to 2008. In 2006-2007 there was fairly widespread discussion that the housing market was over-levered and over-priced—it wasn't a secret that only a few brilliant strategists understood. And yet, most investors blithely marched into the hole without making any adjustments. This time around there has been widespread discussion regarding the extreme rise in Chinese debt, and recently--in the 20 May Wall Street Journal for example--heightened discussion about more Yuan weakness to come. This Yuan weakness is being exacerbated by rising expectations of a Fed rate increase in June/July.

The SPX remains undervalued and should produce much better returns versus the fixed income and other asset classes over a 3-5 year period, but we should continue to prepare for volatility in the months ahead. China looks like a drunk driver careening down the road driving a big truck. It's hard to know who will get run over when it crashes but you know it's not going to be pretty. China is still a net creditor country, like Japan was in 1989, so the greatest damage will remain within China. The U.S. should be more resilient and come out of this accident better than most—just as it did following the Japanese 1989 crackup. The 1990s were a good period for U.S. equities and prospects for the rest of this decade remain positive.

The US dollar has been trading in the range of $1.05 to $1.15 to the Euro since the beginning of 2015 and shows no signs of breaking out of that pattern. The dollar is currently strengthening because of modestly good economic data, but it is unlikely that the Fed will materially raise short term rates in the near future. Perhaps a 0.25% increase will occur this summer, but little more than that. People are still conservative and spending growth is still modest. Furthermore, if there is a break in the Chinese currency and stock market, the Fed will almost certainly put any action on hold and temper any appreciation of the dollar.

Treasury bonds continue to look attractive, but risky bonds less so. Turmoil in China will impact confidence in the global banking system to varying degrees (not so much in the U.S.), and credit markets will likely be under some stress. High quality sovereign debt like U.S. treasuries should perform well but concerns about credit risk will likely negatively impact other securities. UST's are a good hedge for stock risk.

We have been expecting further problems from China and have already been holding higher than normal cash levels. We are not planning to raise additional liquidity at this time. On the contrary, if we get a reasonable leg down in prices thanks to a China panic, our plan is to put our cash back into stocks.
