MARKET ACTIVITY UPDATE

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BACKGROUND

Selling pressure in U.S. equities and global risk markets began early last week, stemmed from downbeat economic data from China, and the surprise devaluation of its currency, the Remnibi. This in turn resulted in a rout of Asian and European markets as well as a renewed plunge in oil prices. Shares came under renewed pressure last Friday afternoon trading as the U.S. oil benchmark slid below $40 a barrel for the first time since February 2009 in response to global demand concerns and a persistent supply glut. The decline has also impacted the price of commodities such as copper and the currencies of several emerging market countries, all of which have hit multi-year lows.

THIS SITUATION IS NOT NEW

Let's revisit a similar situation that occurred in in the second half of 1997, which was triggered in July of that year by a large devaluation of the Thai baht by the Thailand government. The devaluation by the Thai government of the baht by 20% created a contagion throughout Asia, including South Korea, Hong Kong and China. The currencies of other Asian countries such as Indonesia dropped by 30% between September and October of 2007.

The situation finally came to a head on October 23, 1997 when global equity markets experienced a massive downturn. Asian markets fell, such as the Hong Kong Stock Exchange which fell by 10.4%. In the U.S., the S&P 500 was down 6.86% while the Dow Jones suffered its largest point decline in history of 554 points or 7.18%. The S&P 500 bottomed out at 877.01 for the day.To help stem the problem, the IMF and World Bank provided financing to a number of Asian countries to help prop up their currencies and financial systems.

The U.S. economy in 2015 in many ways seems eerily similar to 1997. In that year, the unemployment rate was 5.40%, real GDP growth was 2.40% and inflation was running at 2.60% (Source: CIA World Fact Book). The underlying slow growth of the economy in 1997 help bolster the rebound in equities as the S&P 500 rallied from 877.01 on October 23, and closed the month at 938.92, up 7.06% from the bottom. The S&P 500 closed the year at 963.36, up 33.36% for 1997 (Source: S&P).

IS THIS THE END OF THE BULL MARKET OR A MARKET CORRECTION?

A brief answer to this question can be helped by looking at the economic conditions in the U.S. today. In looking at data provided by JP Morgan for 2015, real GDP growth is estimated to come in at 2.2%, inflation is estimated to be less than 1.0%, and the unemployment rate is at 5.3%. This looks like a mirror image of 1997.

In short, we believe the present downturn in the market is a correction in a multi-year rally. At valuations seen during the second quarter, the market seemingly had limited upside unless we saw an acceleration in earnings growth. The primary threats in the market are the Fed getting ahead of itself in regards to interest rate hikes, and the continuing slow-down in emerging markets on top of the deceleration of growth in developed markets. Worst case, the correlative effect would be a slowdown that could lead to deflationary and ultimately recessionary pressures.

OUTLOOK

Based on present economic data from Wall Street, it appears the world is in a slow growth mode of 2% to 2.5%. With this as a back drop, it seems the Fed may need to push out its first rate hike. This may cause equity markets to fall a bit further, credit spreads to widen further, commodities would continue to decline, and the USD would increase in value versus EM and stabilize versus the Euro and the Yen. In our view, the possibility of equity markets from falling far below present levels is low. Global economies are reaping the benefits from lower oil prices, lower financing costs, global monetary easing and still positive consumer and business sentiment. In addition, the primary drivers in favor of equities remain as cash still offers no yield, investors globally have been waiting for a correction to put cash to work, and bonds with the recent rally offer little upside. We are advising investors to remain calm, and maintain proper diversification.