Breathing Room: January 19, 2016

Could this be a buying opportunity? I don't know, but I do believe this pullback is technical in nature and not some larger fundamental shift in the global macro-economic backdrop. I believe the market correction we have been in this year is largely due to continued concerns over China, oil and the Fed.

Yes, China is second largest economy in the world and sells consumer goods to the rest of the world. But I do not believe they are coming in for a crash landing, despite China's news gripping propensity over the past months. We are in the camp that their economic growth is merely slowing as they undergo an intentional monumental transformation from an export-dependent manufacturer of low-margin trinkets to a consumption-driven economy powered by its own internal growth.

Yes, the selloff in oil continues. Yes, banks have made oil loans. But I believe it is nearly impossible for oil to single handedly pull us into a recession. I do not believe we will see the same wave of bank failures as we did in the 1980s. In the early 1980s, banks made loans on the assumption that oil prices would rise as high as $80 per barrel, and pegged their loans to $70 per barrel. They took huge losses when the price instead crashed below $20 in the mid-1980s. Lending today is much more conservative, and many banks model their loans to assume that oil prices will fall to 65-70 percent of previous higher levels. They also insist that borrowers hedge their commodity prices to avoid market volatility. If you look at the four largest banks in the US, in 2007 their Tier 1 Capital ratio was approximately 7.5% and has grown to approximately 11.6%[1] today; banks are better capitalized than they have been in many decades.

Yes, the Fed bought a lot of bonds during Quantitative Easing (QE) creating an inflow of capital to banks, but they did not in turn lend out all of that money. That is why I don't believe this stock market rise upwards was all driven by some artificial high created by the Fed / QE, and now that the Fed is raising rates the party is over. M2 money supply grew by an average of about 6% over the past six to seven years, and M2 has risen by about 6% over the past twelve months; this to me does not indicate an overly-tightening Fed.

Since March 2009, we have had approximately eighteen 5% pullbacks, and almost every time we have bounced back to new highs. In my opinion this is technical correction and not a fundamental correction in world markets; and I believe we will again bounce back to new highs in 2016. Earnings are coming in strong ex-energy, and I believe they will continue to improve throughout the year.

Portfolio Impact:

Now not to contradict myself, but I do want you all to know that we have continued to make fundamental portfolio changes to protect us, as our models suggest caution going into 2016. A fragile global growth picture and growing pessimism should keep near term pressure on risk assets. Our move to sell emerging markets on August 21st, along with our move out of small caps on December 15th, has helped to lower overall portfolio risk. We will continue to use any near term market strength to continue to fade the high beta/risk trade in favor of a lower volatility focus.

As always, we thank you all for your continued support and look forward to discussing any or all of our thoughts at your convenience.

Best regards,

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[1] Source: Corporate 10-k Filings, FactSet & Bloomberg.

M2 is a measure of money supply that includes savings deposits, money market mutual funds and other time deposits, which are less liquid and not as suitable as exchange mediums but can be quickly converted into cash or checking deposits.

Beta compares volatility of a security with an index, such as the S&P 500. A beta of one means the security has volatility equal to that of an index.