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Our Thoughts on New Year Market Volatility

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World stock markets have gotten off to a very difficult start in 2016. The MSCI ACWI, a broad global benchmark, is down –over 5% since the end of the year, the worst showing since 1988. Following an awful year last year, emerging markets are also down more than -7% (in dollars) in the first two weeks of January. In a replay of the turmoil markets witnessed last summer, the immediate catalyst for the sell-off was events in China. We think the market reaction has been exaggerated relative to the fundamentals.

What Happened?

Chinese shares opened the year by dropping -7% percent, which triggered the government's new circuit breaker rules (more on that in a moment). China's stock market is not like the U.S. stock market. It is highly volatile, dominated by small investors with a history of speculative trading, and is virtually irrelevant to their economy as a whole. Government manipulation of the market is far more overt than in the U.S., and many Chinese traders base their actions on whether and how much the Chinese government is going to support the stock market. China watchers would probably be better off watching electricity generation (a proxy for GDP growth) rather than the stock market.

On January 7, the Chinese market tanked again, and was only open for 14 minutes before it fell the maximum 7 percent, triggering a second market shut down. These circuit breakers have backfired: when stocks start getting close to the first level of -5%, traders race to sell anything they might want to out of fear that they won't be able to if they wait a little longer. That, of course, sends stocks down to the 5 percent threshold, which then gives them 15 minutes to consider selling immediately to avoid being locked completely.

Simultaneously, geopolitical risks are escalating with North Korea conducting a nuclear test and tension growing between Saudi Arabia and Iran. Keying off China, crude oil sank to $33 a barrel and copper dipped below $2 for the first time since 2009. Yesterday, famed investor George Soros exacerbated market jitters by telling an economic forum in Sri Lanka that global markets are facing a crisis (he also called for one in 2011, which didn't happen.) These events have combined to badly frighten investors in the early weeks of the New Year.

How Does this Influence Investment Strategy?

Longer-term momentum is a component of our asset allocation decisions, so continued weakness could prompt a more defensive positioning. This would be a risk-control, money management move. **A longer or deeper decline could trigger changes to our positioning, but it has not as yet.** Versus **fundamentals, these market moves are far exaggerated.** The global economy is O.K. – slowly growing and with low inflation. Just this week the U.S. jobless claims number came in at the lowest rate in years. Economists still expect the U.S. and Europe to strengthen this year, not weaken. Yet investors are giving more credit to falling commodity prices than to manufacturing data. **Declines in oil look scary, but they are the result of a glut of supply, not a decline in demand.**

We have known urbanization-led growth in China has been petering out for at least two years. In their heart of hearts, investors are not looking for even 7% growth anymore – rather they are afraid it is much less. They see a ham-fisted Chinese government response and a currency devaluation that looks suspiciously like an effort to prop up growth by boosting exports.

Unless China is headed for a serious recession (unlikely), the market moves in the rest of the world look overdone. In the developed world, banks have deleveraged and are providing credit to strengthening economies. Commodity prices hurt earnings in the short run but are a boon to consumers. Technological improvements are exciting and ongoing.

What should we do?

Unless your needs have changed, most likely there is no need to alter your course. Asset class diversification is working as high quality bonds are holding up fine. For stocks, the tail is wagging the dog – this is market volatility, not fundamental change in the economic or market outlook. These events may shift what we are monitoring, but not investment opportunity set, at least as yet. If anything, deeper declines in international markets would make us more interested in taking advantage of lower prices there. We continue to pursue differentiated, uncorrelated alternative investments as a priority for our investors, especially replacements for traditional bonds.

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