Summa Global Advisors

Perspective Newsletter Vol. 2, 2016

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Tug of War
Existing Bull vs. Lurking Bear

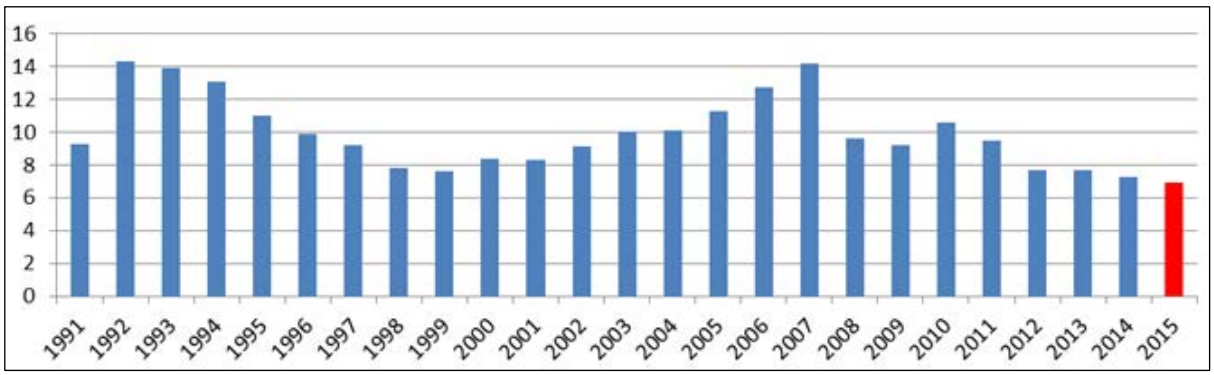
The first quarter of 2016 was a roller coaster! The US economic and market recovery from the 2008-09 recession is the longest in recent history. After such a sustained bull market, the bear is waking up from its hibernation. What market conditions lie ahead for investors during 2016? Investor sentiment is responding to five major factors that have influenced the US stock market over the past few months:

1. *The 2016 US Election.* The current US political environment has been one of contention. There is a high degree of concern over future economic policies, especially domestic and foreign policies that the next President may choose to implement.

2. *The Federal Reserve and global monetary policies*. The Fed's December interest rate hike affected markets around the world. International currencies have been influenced by the strong US dollar, creating a period of higher currency exchange rate volatility. Such volatility significantly impacts corporate profits and prices of both imports and exports of commodities and other goods.

Central Bank Quantitative Easing (QE) is also of great concern. QE is when the central bank buys assets from investors, flooding the market with cash. Mohamed A. El-Erian, chief economic adviser at Allianz, writes, "Now these monetary institutions are expected to continue producing miracles. But their ability to repeatedly pull new rabbits out of their policy hats has been stretched to an increasingly unsustainable degree."[1]

3. *The Chinese economy*. The near-term outlook for China is uncertain, and economists are concerned about a "hard landing" for the economy. As a result, many investors have reduced their holdings in China. As the world's second largest economy, China is in a period of transition from a manufacturing to a consumption-based economy. China's economic slowdown created a drop in demand and prices of basic commodities have plummeted.



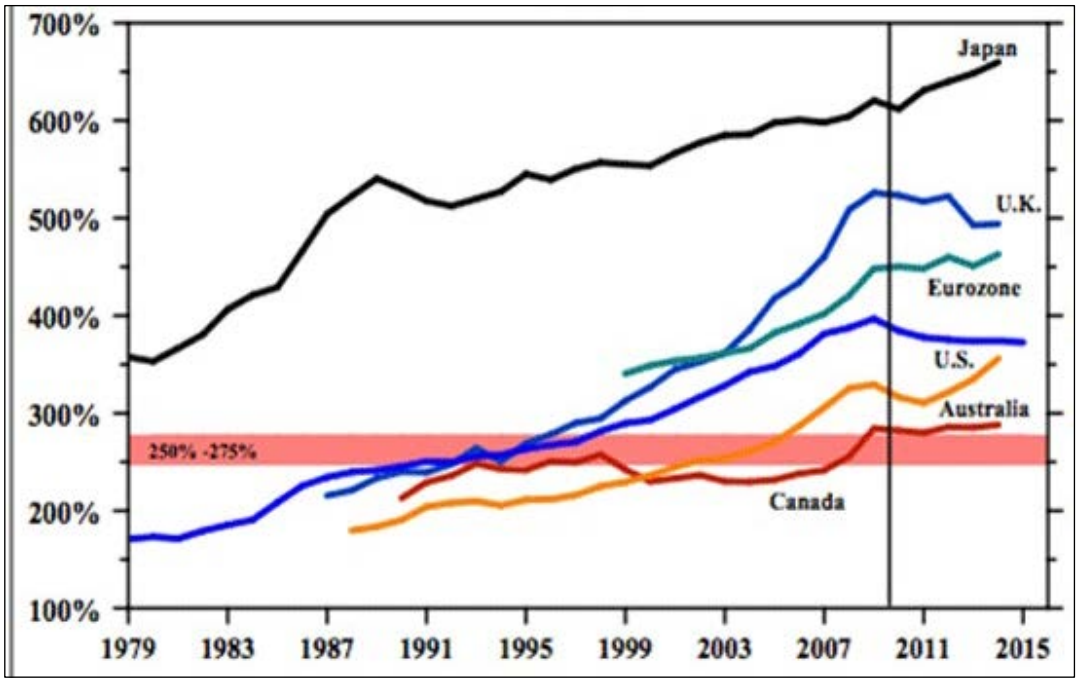
Chinese GDP by Year
Source: DailyFX

4. *Equity valuations*. John Hussman of Hussman Funds believes that current market valuations are extremely high while "investors have openly embraced rich valuations in the belief that they represent some new, modern and acceptable 'norm.'"[2]

CMG Capital Management's Steve Blumenthal agrees with Hussman. "Valuations are way too high and probable forward returns are low. Risk is high."[3]

5. *The long-term debt cycle*. Most of the leading industrial economies have significantly increased their debt in past decades (see chart below).

"The bear is waking up from its hibernation"



Total Private and Public Debt (% of GDP)
Source: Hoisington Quarterly Review and Outlook – 3Q2015

By the Fed and many economists' standards, raising rates seems timely. But in his January 25, 2016 article, Ray Dalio, founder of Bridgewater, a large hedge fund, makes a different argument:

> Dalio: *However as I see it, there are two important cycles to pay attention to---the business cycle, or short-term debt cycle, and the debt supercycle, or long-term debt cycle. We are seven years into the expansion phase of the business/short-term debt cycle—which typically lasts about eight to 10 years—and near the end of the expansion phase of a long-term debt cycle, which typically lasts about 50-75 years. It is because of the long-term debt cycle dynamics that we are seeing global weakness and deflationary pressures that warrant global easing rather than tightening. What I am contending is that there are limits to spending growth financed by a combination of debt and money. When these limits are reached, it marks the end of the upward phase of the long-term debt cycle.*[4]
>
> Blumenthal: *"I believe we need to recognize that we are dealing with a global debt deleveraging cycle that has happened many times in history, but it tends to occur maybe just once in an individual's lifetime."*[3]

Global growth continues to be sluggish at best. International Monetary Fund (IMF) in January projected a 3.4% growth for the world (see graph on next page), which has just been revised down to 3.2% on April 12.[5]

World Economic Outlook Update, January 2016
Source: IMF

More deflationary pressure may still be ahead. As you can see, even the brightest minds on the planet hold varying theories about the current state of the global economy. As events unfold, investors must anticipate greater stock market volatility and have a game plan to manage that.

Footnotes:
1. *The Only Game in Town*. Mohamed A. El-Erian.
2. *Run-of-the-Mill vs. Worst Case Scenarios*. John Hussman. March 28, 2016
3. *On My Radar: Fed Stuck Between Three Rocks and a Hard Place*. Steve Blumenthal. April 4, 2016.
4. *Pay Attention to Long-Term Debt Cycle*. Ray Dalio. January 25, 2016. Full article at http://on.ft.com/1NxSq4z
5. Details at http://www.imf.org/external/pubs/ft/weo/2016/01/index.htm