

China: Syndrome, Symptom Or Both?

Unsettled Capital Markets

The August devaluation of the Chinese yuan unsettled worldwide capital markets. China's equity markets plummeted from their exorbitant highs and the U.S. equity markets lost more than 10% of their value in the two weeks following the announcement. Investors questioned whether the devaluation was in response to an alarming decline in China's economy or merely a hedge against slowing growth and declining export activity. Was there an inherent problem with China's economy or was the slowdown symptomatic of a worldwide economic malaise that dampened demand for imports from China? In particular, was it the after effects of Europe's economic problems and lackluster demand in the United States? In the U.S., the S&P 500 struggled back only to lose ground again as the quarter drew to a close. The volatility persisted and the swings were substantial (at home and abroad) after the Federal Reserve deferred its decision to raise interest rates, further fueling investor concerns over worldwide economic headwinds and the potential for deflation.

It is likely that China is suffering an internally driven slowing of its economy. Housing construction, a large driver of its economy, has plateaued. Practical limits are materializing as to the amount of infrastructure spending and the timing of such expenditures. Although it is the government's goal that the economy become more consumer driven, and thus self-sustaining, such transformation will likely have a long time horizon. It will likely require additional structural reforms including a social safety net to encourage consumer spending and lessen reliance on savings. Finally, the decline in export activity in conjunction with these factors leads many analysts to conclude that China's economy will grow significantly less than the government's target rate of 7%. Complicating the matter further is the lack of transparency regarding China's economic data and concern over troubled loans in the private sector and shadow banking system. Nevertheless, China's government is committed to preventing a hard landing, and presently has sufficient resources to create further liquidity and support a reasonable, though more modest, level of growth. There is still room, for example, for China to increase government debt levels above the present level of approximately 110% of its GDP.

So it seems that it is an internally driven syndrome complicated by symptoms of contagion from the muted worldwide economy.

During this period of volatility, attention was diverted away from Greece and its economic and debt problems and refocused on Asia where the contagion effect from a slowing China is pronounced. As demand for commodities lessened, commodity dependent developed and developing economies suffered. The emerging markets drastically sold off as capital fled, and EM currencies suffered substantial losses relative to the US dollar and the Euro. Although U.S. exports to China are estimated to be less than 1% of U.S. GDP, U.S. exports to emerging market countries negatively impacted by the reduction in China's economic activity are meaningful and have come under pressure.

As equity markets roiled (attempting to regain ground only to again lose its footing to weak economic data domestically and abroad) investors focused on the Federal Reserve and anxiously awaited the September decision regarding interest rates only to have the Fed defer its much anticipated move to raise interest rates.

The Federal Reserve

The decision by the Fed not to raise interest rates heightened investor fears that the Fed's caution signaled concern over further worldwide economic slowing, deflationary pressures and currency headwinds. Global equity markets continued their selloff in the wake of the Fed's decision.

The Fed's caution as to the impact that foreign economies exert on the U.S. economy and the earnings of multinational corporations has underscored for investors the interdependence of domestic and foreign economies. Notwithstanding the relative health of the U.S. economy and its near full employment performance, the Fed opted to defer the commencement of its program to increase interest rates. Post announcement, the Fed chair advised that the Federal Reserve was still on track to raise interest rates this calendar year. While temporarily comforted by the statement that indicated confidence in the U.S. economy, capital markets then quickly sold off concluding that uncertainties and risks have multiplied.

The Federal Reserve understands that China and emerging market economies have slowed to the point that their central banks will pursue stimulative policies that together with the weakening of their currencies will provide competition for U.S. based manufacturers. U.S exports through July were down 3.5% compared with the same period last year. Investors are also wary of the sharp decline in commodity prices and the impact that such has on commodity dependent economies such as Canada, Australia, and Brazil.

The decline in commodity prices (evidence of weak demand) and the strength of the dollar relative to foreign currencies have created doubts as to whether the Fed's target inflation rate of 2% is realistic. With only minimal domestic wage gains, excess capacity, low commodity prices and a strong dollar, the engine of inflation continues to idle.

Finally, the Fed is acutely aware of the demographic and cultural changes also impacting the near and longer-term outlook for the economy. As the baby boomer generation leaves the workforce and the millennial generation enters the workforce income levels and spending patterns will adjust. This will impact sector and overall GDP growth. The nature of the jobs being created and the skills required for these positions is also morphing. There has been much coverage regarding the mismatch of skills and open jobs that need to be filled by employers. Technological advances will continue to impact operating efficiencies thereby recalibrating pay levels and personnel requirements. Analysts and economists continue to debate whether the jobs being created are of sufficient quality and pay scale to support economic growth.

While there is much focus on the Fed, investors and economists believe that monetary policy has limited efficacy at this point to advance the economy although there is great concern that premature tightening of interest rates could adversely impact the economy. Absent fiscal policy intervention (i.e., tax reductions and/or increased government spending) to accelerate growth, the economy's pace of growth is likely to remain unchanged as it works through excess capacity,

currency imbalances, interest rate levels and equity valuations. Given the current political environment we are not optimistic about constructive fiscal policy in the near term.

The Markets

For the quarter, the Dow Jones Industrial Average declined -6.98% (-6.95% ytd); the S&P 500 and Russell 1000 Indices declined -6.44% (-5.29% ytd) and -6.83% (-5.24% ytd), respectively. The Wilshire 5000 declined -8.58% (-7.05% ytd). The MSCI EM Index declined -17.9% (-15.47% ytd). The Russell 2000 Small Cap Index declined -11.92% (-7.73% ytd) while the S&P 400 Mid Cap Index declined -8.5% (-4.66% ytd). The MSCI EAFE Index declined -10.23% (-5.28% ytd). The MSCI All Country World Index declined -9.45% (-7.04% ytd), and the MSCI European Equity Index declined -8.69% (-5.2% ytd) net of currency losses.

Portfolio Construction

At quarter close, the price-earnings ratio for the S&P 500 was approximately 17.3x 2015 estimated EPS. Mid- and small-cap shares are valued at approximately 20.4x and 23.5x 2015 estimated EPS, respectively. In most client portfolios we remain modestly underweight large-cap shares and modestly overweight mid- and small-cap shares.

With long-term Baa corporate bonds yielding approximately 5.0%, the implied PE ratio for equities is 20x. We continue to believe that the driver of share price increase going forward will be growth in EPS rather than multiple expansion and continue to anticipate this growth to be modest and gradual. Nevertheless, diversified domestic equities continue to represent a competitive investment on a relative risk/reward basis as compared to other asset classes. We continue to maintain exposure to both growth and value equities and to both passive and active styles of management in most client portfolios.

Most client portfolios are underweight foreign equities with a substantial portion of such foreign equity exposure hedged back to the U.S. dollar to mitigate the impact of currency conversion on client portfolios.

We continue to have modest duration exposure in most fixed income portfolios, and continue to invest in high quality municipal bonds held as a risk mitigator. We anticipate that the Fed will be cautious in raising rates so as not to upset the trend of improving economic conditions. Interest rates declined during the quarter with the 10-year treasury closing at a yield of 2.06% (6 basis points less than the 2.12% yield at the start of the year). The two-year and five-year treasury yield at quarter end were both lower than at the beginning of the year (2 and 24 basis points, respectively).

Outlook

Economists were, prior to recent market volatility, forecasting higher U.S. economic growth during the second half of the year and the recent upward revision of second quarter GDP growth to 3.9% was encouraging. Including the slight contraction in the first quarter of the year,

consensus outlook is for annual growth of 2.5 - 3% in 2015 with Europe delivering significantly slower growth and emerging markets remaining under stress.

Increased interest rate spreads over treasury securities have signaled that risks are climbing. These higher rates for corporate credit and high yield bonds notwithstanding, we view the present level as richly priced by comparison to equities.

We continue to anticipate a tepid growth environment and continued volatility in the capital markets as international macro-economic relationships adjust while central bank policies support recovery. The equity markets are presently working through their own repricing of risk and though volatile are trading within a range that will be more supportable by anticipated 2016 corporate earnings, resulting in lower PE multiples for equities.

Postscript

Two days after the close of the quarter (yes, it is October) capital markets awakened to disappointing news with regard to the U.S. economy. Nonfarm payrolls in September increased by only 142,000 jobs as compared to the forecasted 206,000 jobs. August jobs numbers were revised downward to 136,000 jobs from the initial reading of 173,000. July was also revised down to 223,000 jobs from the initial reading of 245,000. Wage increases in September were flat following a 9 cent per hour gain in August. The unemployment rate remained unchanged at 5.1%.

The equity markets vigorously reacted to the disappointing news selling off sharply at the open, only to rally back during the day. Interest rates declined throughout the yield curve with the 10-year treasury falling below 2%. Concerns over deflation again came to the fore.

The jobs numbers during the third quarter are indicative of a tepid domestic economy and casts doubt on the outlook for earnings in 2016. Composite S&P 500 earnings from domestic operations thus far in 2015 excluding the energy sector have reflected reasonable growth while earnings from international operations have generally negatively impacted overall earnings growth. We anticipate a gradual and protracted economic and earnings recovery.

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.

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